IN THE

Supreme Court of the United States

OCTOBER TERM, 1969

No. 282

UNITED STATES OF AMERICA,

Petitioner,

—v.—

MACLIN P. DAVIS and EDITH U. DAVIS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

(Civil Action No. 4479)

[Caption Omitted]

DOCKET ENTRIES

June 17, 1966	Complaint filed.
June 17, 1966	Summons issued to U. S. Marshal with 6 attested copies of complaint for service on defendant. ($3.00 check payable to the Marshal delivered.)
June 21, 1966	Return on Service of Summons filed. MEF $3.00.
August 16, 1966	Answer of Defendant filed, Certificate of Service attached.
October 19, 1966	Plaintiffs' Motion for Summary Judgment, Certificate of Service attached; Brief in Support of Motion; Affidavit of Maclin P. Davis; and Affidavit of Lee Davis, filed.
November 4, 1966	Affidavit of H. Stennis Little, Jr. attorney for defendant, filed. Requested that no hearing be set on plfs' motion for summary judgment before Dec. 15, 1966 (Attested copy to U. S. Attorney) Certificate of service attached.
December 16, 1966	Filed: Discovery Deposition of Mr. Maclin P. Davis taken by defendant Dec. 1, 1966.

May 10, 1967	Cross-Motion for Summary Judgment, Affidavit of H. Stennis Little, Jr., and Brief in Support of Cross-Motion filed on behalf of defendant.
July 11, 1967	Order Entered: It is the Court's Understanding parties agree oral hearing not necessary; Plaintiffs allowed 15 days to submit supplemental brief, Defendant allowed 10 days thereafter to file reply. (Attested copy to attorneys of record)
July 24, 1967	Affidavits of Maclin P. Davis, Jr., and William Waller filed on behalf of plaintiffs, Certificate of Service (letter) attached.
July 24, 1967	Filed: Reply of Plaintiffs to Brief for the Defendants in Support of its Cross-Motion for Summary Judgment, Certificate of Service (Letter) attached.
August 4, 1967	Supplemental Memorandum for Defendant filed, Certificate of Service attached. (2 att. copies delivered to U. S. Atty)
September 15, 1967	Memorandum of the Court entered, appropriate order to be submtited within twenty days (Attested copies to attorneys of record).
October 5, 1967	Order of Judgment entered: Plaintiffs to recover $12,910.51 with 6% interest from and after Nov. 15, 1965, and costs (Certified copy delivered to the office of the U. S. Attorney; attested copies mailed to attorneys of record William Waller and H. Stennis Little, Jr.)
October 9, 1967	Motion for Rehearing filed on behalf of defendant, Certificate of Service attached.

October 19, 1967	Order Entered: Defendant's Motion for rehearing denied (Attested copy to attorneys of record).
December 1, 1967	Notice of Appeal filed on behalf of the defendant, U.S.A., certificate of service attached.
January 10, 1968	Entered: Order extending time for docketing appeal in the Court of Appeals to and including Feb. 9, 1968 (Attested copy to attorneys of record).

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

[Caption Omitted]

RELEVANT DOCKET ENTRIES

February 7, 1968	*Certified record* (1 vol. pleadings), filed; and cause docketed
December 11, 1968	Cause argued and submitted (Before: O'Sullivan, Celebrezze and McAllister, JJ.)
March 27, 1969	Judgment of the District Court affirmed
March 27, 1969	Opinion by Celebrezze, J. 8pp.
April 17, 1969	Mandate issued (No costs taxed)

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

COMPLAINT

(Filed June 17, 1966)

Statement of Jurisdiction

1. The plaintiffs bring this action against the United States of America for the recovery of income taxes for the calendar year 1963, pursuant to provisions of 28 U.S. Code Section 1346(a)(1). Plaintiffs are husband and wife and are residents of Davidson County, Tennessee. They filed their joint return for 1963 with the District Director of Internal Revenue at Nashville, Tennessee.

Statement of Claim

2. In 1945, plaintiff, Maclin P. Davis, hereafter referred to as plaintiff, purchased from Tennessee Foundry & Machine Company of which he was and is President, 1,000 shares of 6 per cent preferred stock issued by said corporation at $25 per share. Such purchase was for the purpose of fulfilling a condition precedent to the obtaining of a loan by such corporation from Reconstruction Finance Corporation. The additional capital was paid in to such corporation by the plaintiff for the particular purpose of enabling it to obtain said loan, was always intended to be temporary in nature, and was paid in with the understanding between such corporation and the plaintiff that said preferred stock would be redeemed by the corporation after said loan was paid. Said loan from Reconstruction Finance Corporation was paid in full in 1963, whereupon the corporation redeemed plaintiff's preferred stock for $25,000. Relying on Section 302 of the Internal Revenue Code, the Internal Revenue Service erroneously treated such redemption as a dividend to plaintiff and assessed additional income tax in the amount of $11,474.34, treating the proceeds of such redemption as ordinary income.

3. On or about November 15, 1965, plaintiffs paid to the District Director of Internal Revenue at Nashville, Tennessee the assessed additional income tax of $11,474.34, based on the assessment referred to in paragraph 2 hereof, plus assessed interest, or a total of $12,910.51. Plaintiffs thereafter, on or about December 7, 1965, filed a timely claim for refund, setting forth the grounds hereinabove alleged. Plaintiffs allege that said tax and interest were illegally collected and accordingly allege that they are entitled to a recovery of the aforesaid additional tax, together with assessed interest paid by them, and interest as provided by law.

Relief Prayed

4. Wherefore, plaintiffs demand judgment against the defendant for $11,474.34 overpaid on their 1963 income taxes, plus assessed interest, making a total of $12,910.51, together with interest and costs as provided by law; and plaintiffs pray for such additional relief as they may be entitled to.

WALLER, LANSDEN & DORTCH

By /s/ WILLIAM WALLER

/s/ ROBERT G. MCCULLOUGH
Partners
Attorneys for Plaintiffs
1200 American Trust Building
Nashville, Tennessee 37201

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

ANSWER

(Filed August 16, 1966)

The defendant, the United States of America, by its attorney, Gilbert S. Merritt, Jr., Esquire, United States Attorney for the Middle District of Tennessee, for its answer to the complaint, herein alleges as follows:

1. Admits the truth of all allegations contained in paragraph 1.

2. Denies the truth of all allegations contained in the last sentence of paragraph 2. The defendant is currently without information sufficient to form a belief as to the truth of all other allegations contained in paragraph 2.

3. Denies the truth of all allegations contained in the first sentence of paragraph 3 and alleges that a total of $12,878.15 was paid on November 16, 1965. The defendant denies all other allegations contained in paragraph 3, except admits that a timely claim for refund was filed on December 7, 1965.

WHEREFORE, the defendant prays that the complaint be dismissed with prejudice, and that the defendant be allowed its costs and disbursements.

/s/ KENT SANDIDGE, III
Assistant United States Attorney

* * * *

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

MOTION FOR SUMMARY JUDGMENT

(Filed October 19, 1966)

Plaintiffs move the Court to enter, pursuant to Rule 56 of the Federal Rules of Civil Procedure, a summary judgment in plaintiffs' favor for the relief demanded in the complaint, on the ground that there is no genuine issue as to any material fact and that plaintiffs are entitled to a judgment as a matter of law.

This motion is based upon:

(a) The pleadings.

(b) The affidavit of Maclin P. Davis taken on October 5, 1966, which is filed herein.

(c) The affidavit of Lee Davis taken on October 18, 1966, which is filed herein.

(d) Plaintiffs' brief in support of motion for summary judgment which is attached hereto and made a part hereof.

WALLER, LANSDEN & DORTCH

By /s/ WILLIAM WALLER

/s/ ROBERT G. MCCULLOUGH
Attorneys for Plaintiffs
1200 American Trust Building
Nashville, Tennessee 37201

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UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

AFFIDAVIT IN SUPPORT OF PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT

(Filed October 19, 1966)

STATE OF TENNESSEE)
)
COUNTY OF DAVIDSON)

MACLIN P. DAVIS, being duly sworn, deposes and says:

1. I am one of the plaintiffs in the above styled case and I am making this affidavit as to facts within my own knowledge in support of plaintiffs' motion for summary judgment.

2. I am President of Tennessee Foundry & Machine Company and have served as President since its incorporation on April 20, 1945, as successor to a going business theretofore operated as a partnership. A copy of the Certificate of Incorporation is annexed hereto as Exhibit A. Before this corporation was organized, I applied to the Reconstruction Finance Corporation and The American National Bank, of Nashville, Tennessee, for a loan of $95,000 to be made to the corporation when organized. In the course of negotiations and conversations regarding this loan, I was advised that the corporation would be required to deposit in a bank a minimum of $25,000 to be used as additional working capital, to be obtained either by the sale of preferred stock or by the issuance of a subordinated deferred note. In order to obtain the loan for the corporation, I agreed to provide the necessary working capital for the corporation. My agreement in this regard is set forth in a letter dated April 25, 1945, to The American National Bank, a copy of which is annexed hereto as Exhibit B. The approval of the loan by the Reconstruction Finance Corporation is shown

by its letter dated May 2, 1945, annexed hereto as Exhibit C, expressly providing that its approval is subject to certain enumerated terms and conditions, including the condition that the borrower have a minimum of $25,000 on deposit to be used for working capital. Annexed hereto as Exhibit D is a letter dated May 3, 1945, from The American National Bank to Smaller War Plants Corporation stating that no part of the loan would be disbursed until the required $25,000 had been deposited. As mentioned above, it was agreed that I could provide the necessary working capital either by loaning the money to the corporation and taking a subordinated deferred note or by purchasing preferred stock. I decided to purchase preferred stock because I was told that this would be preferable from the standpoint of the corporation's balance sheet. The charter, Exhibit A hereto, was drafted so as to authorize 1,000 shares of preferred stock, par value $25 per share, all of which I purchased on the dates and in the amounts shown by copies of my personal checks which are annexed hereto as Exhibit E. It was my intention at that time to hold the preferred stock only as long as was necessary to comply with the conditions of the loan from Reconstruction Finance Corporation and The American National Bank. Paragraph 7 of the Reconstruction Finance Corporation letter, Exhibit C hereto, provided that I agreed to not withdraw from the corporation any funds in excess of a specified salary, and it was my understanding that this agreement prohibited redemption of the stock. It was always understood and agreed between myself and the corporation that my preferred stock would be redeemed as soon as the loan was paid.

3. After the obtaining of the $95,000 loan in 1945, it became necessary to refinance and increase the loan to $110,000 in 1946. A copy of the letter of Reconstruction Finance Corporation dated July 16, 1946, agreeing to the increase in the amount of the loan is annexed hereto as Exhibit F. Due to financial difficulties of the corporation during these years, it was necessary to reduce the amount of the monthly payments and extend the loan.

The final payment on the loan was made on June 1, 1963. At a special meeting of the Board of Directors of the corporation called and held on September 23, 1963, the following resolution was adopted:

> WHEREAS, Maclin P. Davis, holder of 1,000 shares of the preferred stock of the corporation, which was originally issued to him for the consideration of $25,000, has offered to accept the sum of $25,000 for said preferred stock;
>
> BE IT RESOLVED, That the 1,000 shares of Preferred Stock held by Maclin P. Davis be redeemed by acceptance of his said offer and the payment to him by this corporation of $25,000 for said stock, which payment shall take place on October 1, 1963, upon the surrender of the certificates for said 1,000 shares of Preferred Stock; and
>
> BE IT FURTHER RESOLVED, That the Treasurer is directed and authorized to cause the same to be paid on the date specified.

In accordance with the resolution quoted above, I surrendered my certificate representing the 1,000 shares of preferred stock and received a check of the corporation for $25,000.

4. The examination report of the Internal Revenue Service, dated June 11, 1965, states that ". . . a redemption of stock which does not change the essential relationship between the shareholder and the corporation is considered to be equivalent to a dividend. The taxpayer, by virtue of the percentage of shares of common stock owned by him individually . . . and constructively . . . was solely in control of the corporation both before and after redemption of the preferred stock." The explanation then says that the distribution in redemption is accordingly considered to be the "equivalent of a dividend."

5. As is shown by the Charter of Tennessee Foundry & Machine Company, Exhibit A hereto, a total of 1,000 shares of no par common stock are authorized in addition to the 1,000 shares of preferred stock. At the time

the corporation was organized, I subscribed to 250 shares of the common stock, my wife subscribed to 250 shares, and E. B. Bradley subscribed to 500 shares. Ownership of the common stock remained the same until 1952 when I bought the 500 shares of common stock owned by Mr. Bradley. In 1959, I transferred 250 shares to my son and 250 shares to my daughter. There have been no further transfers of common stock.

6. In 1960 Tennessee Foundry & Machine Company sought and obtained the consent of Reconstruction Finance Corporation to the payments of dividends on the common and preferred stock. Beginning on October 5, 1960, regular semi-annual dividends were paid on both the common and preferred stock.

/s/ MACLIN P. DAVIS

* * * *

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

AFFIDAVIT OF LEE DAVIS

(Filed October 19, 1966)

STATE OF TENNESSEE)
)
COUNTY OF DAVIDSON)

LEE DAVIS, being duly sworn, deposes and says:

1. I am a resident of Davidson County, Tennessee, and am a financial counselor with my office on the 23rd floor of the Life & Casualty Tower, Nashville, Tennessee. I have read the affidavit of Maclin P. Davis with regard to the above case, and I am familiar with certain of the transactions described in his affidavit. I am making this affidavit as to facts within my own knowledge.

2. I was employed by Reconstruction Finance Corporation at its office in Nashville, Tennessee, from the date it opened on March 10, 1932, until it closed on October 1, 1953. I served as Assistant Manager of the Nashville office from sometime in 1932 until 1950 and as Manager thereafter. In my capacity as Assistant Manager, I personally supervised the loan of Reconstruction Finance Corporation to Tennessee Foundry & Machine Company in 1945, in which The American National Bank participated to the extent of 10%. Tennessee Foundry & Machine Company was a new corporation but it was a successor to a business which had been operated as a partnership and was considered by RFC as a going concern. When the application for a loan was made, I determined, in accord with our standard policy and in concurrence with the Agency Manager and the Bank, to require the principals of the business to provide additional working capital in the amount of $25,000. It was a standard procedure of RFC to require, as a condition of a loan, that additional money be provided to the corporation, to be

retained in the corporation as long as the loan was outstanding or until the lender gave its consent to any modification. It was immaterial to RFC whether this money was put into the corporation as a purchase of preferred stock or common stock or as a subordinated loan. The requirements imposed upon Tennessee Foundry to obtain this loan were not unusual but in fact were standard requirements and conditions required of any borrower at the time the loan was made in order to provide sufficient operating capital. I have been shown a copy of a letter dated May 2, 1945, from RFC to The American National Bank concerning this loan over the signature of J. M. Gardenhire, Manager, whose signature I recognize. The condition expressed in paragraph 7 of that letter was included to prevent Tennessee Foundry from redeeming the preferred stock sold to Mr. Maclin Davis as long as the loan was outstanding.

3. I have noticed that certain of the correspondence, copies of which are annexed to the affidavit of Mr. Maclin P. Davis, are addressed to Smaller War Plants Corporation. This was a corporation organized by the United States Government to make particular types of loans in connection with the war effort. This corporation was subsequently merged into Reconstruction Finance Corporation and at all times was operated by RFC with RFC personnel. In other words, for all practical purposes, there is no distinction between Smaller War Plants Corporation and RFC.

/s/ LEE DAVIS

* * * *

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

DISCOVERY DEPOSITION OF
MR. MACLIN P. DAVIS

(Filed December 16, 1966)

[fol. 1] The deposition of MR. MACLIN P. DAVIS, taken on discovery on behalf of the defendant, at the offices of Waller, Lansden & Dortch, 1301 American Trust Building, Nashville, Tennessee, pursuant to agreement of counsel as to time and place of taking, commencing at eleven o'clock, a.m., on December 1, 1966, before Mrs. Helen S. Draper, a notary and Court reporter for Davidson County and the State of Tennessee.

All formalities as to notice, caption and certificate are waived, and it was stipulated by and between counsel that the signature of the witness to his deposition is waived.

APPEARANCES:

For the Plaintiffs:

HON. WILLIAM WALLER, and
HON. ROBT. G. MCCULLOUGH,
Of Waller, Lansden & Dortch
American Trust Building
Nashville, Tennessee

For the Defendant:

HON. STENNIS LITTLE, JR.,
Tax Division
Department of Justice
Washington, D.C.

[fol. 2] MR. MACLIN P. DAVIS

having been first duly sworn, was examined and deposed as follows:

BY MR. LITTLE:

Q Would you please state your name and address, sir, for the record?

A Maclin P. Davis, Nashville, Tennessee.

Q Now, just generally when was the Tennessee Foundry and Machine Company started?

A In 1945.

Q Now, do you recall the original capital contribution that was made to the corporation, in addition to the $25,000 that you contributed for the preferred stock?

A Well, it was in assets valued at approximately twenty thousand dollars.

Q What sort of assets were they?

A Well, it was machinery that I had owned through the liquidation of the Seling Aircraft Corporation.

Q Now, what about Mr. Bradley, did he make a capital contribution?

A He purchased the property, he and a fellow, I believe his name was Gilliam, and operated as a partnership prior to my getting into it, and I came into it after Mr. Gilliam left.

Q So he owned part of the assets that were transferred to the corporation?

[fol. 3] A That's right.

Q I see. Now, was there any other cash contributed to the corporation that you can recall?

A Not by me.

Q What about Mr. Bradley?

A Yes, he paid cash for the property, he and Mr. Gilliam, the property where the Tennessee Foundry & Machine Company is now located, part of that property.

Q But wasn't that before you contributed the assets for the corporation?

A Yes, sir.

Q But now, I'm talking about when you made the capital contribution to the corporation in addition to those assets we are talking about. Was there any other cash contributed other than the $25,000?

A I don't know what the deals between Mr. Bradley and Mr. Gilliam were, and how much cash they put in,

other than that they owned this property, this building and the real estate there.

Q Was Mr. Gilliam a shareholder in this corporation?

A No, sir.

Q He was out of it, then, when you transferred it? Is that right?

A When we transferred it. That's right.

Q So you just don't recall whether or not the Com- [fol. 4] pany had any cash at the time they started in 1945, in addition to the equipment?

A Yes, they had, because they had been operating.

Q So in addition to the equipment, you transferred all the assets of the partnership, is that the way it was?

A I don't quite follow you.

Q Well, in addition to the machinery we're talking about, did you transfer other assets? The partnership had other assets other than the machinery?

A Oh, yes, they had some accounts receivable and a small inventory. It wasnt' a big company. It was a small organization.

Q Yes, sir, that's what I was getting at. Now, you have submitted an affidavit giving us some details on exactly the transaction involved with the Reconstruction Finance Corporation and the American National Bank of Nashville, but now for purposes of this deposition, if you would, just give us in your own words some information pertaining to that loan, just more or less give it to us in your own words right now, if you don't mind.

A Do you mean the reason for applying for the loan and so on?

Q Yes, sir.

A Well, the loan was to build the foundry building that we have there now, and to get a large foundry [fol. 5] operation in there, and that was the purpose, why I was interested in going in with Mr. Bradley, you see, the expansion of the business from the partnership that he had.

Q Now, who was it exactly that required the additional $25,000 contribution?

A The RFC.

Q So now the corporation went along and in 1963 they ultimately paid off this loan. Is that correct?

A That's correct.

Q And then subsequent to that, the corporation, that is the Tennessee Foundry & Machine Company, paid you $25,000 for all of your preferred stock?

A Yes.

Q Now, at the time that the corporation, the Tennessee Foundry & Machine Company, paid you the $25,000, Mr. Davis, how much stock did you own in the corporation?

A I personally owned 250 shares of the common stock.

Q And who else at that time—

A My wife owned 250 shares of the common stock. My daughter owned 250 shares, and my son owned 250 shares.

Q Now, that was immediately prior to the—

A Well, they owned that possibly several years before.

Q Prior to your receiving the $25,000?

A Yes, sir, several years.

Q And after?

[fol. 6] A Oh, yes, they still own the same amount.

Q Now, at the time that the corporation decided to give you the $25,000 for all of the preferred stock of the corporation, what caused the corporation to give you this at that time?

A Well, they were in a position to pay it off without having to borrow any money. We haven't borrowed any money from anybody since that has been paid off. It was surplus money and, as I stated before, it was my understanding that when the RFC would be liquidated and the bank loans were liquidated, it would be redeemed.

Q Well now, was there any business reason at that time to give you $25,000 for all of your preferred? And when I say "business reason", I am referring to corporate business reason.

A Well, it had this cash in the bank and the corporation was paying 6% on it, and it relieved the corporation of paying that, that's the only thing. I mean the corporation had the cash, the money to pay it off according to understanding, according to agreement, and we

did not have to do any financing whatsoever in order to pay it off. And since that date, since 1963, the Company has still operated without having to replace that. I mean that we took $25,000 out of the cash account of the Company and we're still operating and we haven't borrowed any money to supplement it.

[fol. 7] Q Well now, other than just the corporation had the cash and was able to pay you $25,000 for the preferred stock, can you think of any compelling business reason that the corporation would have to give you $25,000 for it at that time? I'm talking about 1963.

A "Compelling reason", I don't understand.

Q Well, business reason or—

A Business reason was that when I put the $25,000 in in 1946, it was understood that when the RFC loan was paid off that the corporation would redeem that preferred stock, and those things had been done and the Company was in financial position to retire it without jeopardizing the financial position of the Company, and that is why it was carried out. The agreement was carried out that had been made twenty years prior to it.

Q Do you recall any particular reason when the corporation was formed and this additional $25,000 was required by the lender that you did not just get a note back from the corporation say, first?

A Well, that was discussed. I mean in order to get the loan of $95,000 from the RFC they wanted $25,000 worth of additional, I think the word they used, "equity" in the Company, and that I could take it either in preferred stock or a subordinated note, anything that that $25,000 would have to be subordinated to this $95,000 loan.

[fol. 8] Q Well, that was a requirement of the RFC in order to get the $95,000 loan, see, and the decision to take it out in preferred stock rather than a note was done because in the financial statement it would have shown up as an equity rather than as a liability, a note liability, and so that was the reason for the preferred stock. We decided, "Well, all right, take it out in preferred stock rather in a subordinated note."

Q What about the common?

A Well, the common was there.

Q Did you think about taking additional common, giving you a higher percentage of the ownership?

A No, the whole thing was that here was an agreement to retire this $25,000.

Q You were thinking about ultimately getting this back?

A I don't follow you, "ultimately". What do you mean?

Q Well, could you have not received this back if you had had common stock in the same manner that you did—

A I didn't put in the common stock, I already had the common stock. The agreement was based on this $25,000, how the $25,000 would be put in, and it was to be put in—I mean with the RFC and the American Bank—either by a subordinated note or preferred stock.

Q But they wouldn't have cared whether it was preferred or common?

A No common. They said how it would be put in, [fol. 9] all the discussion was based on this $25,000 would be either in preferred stock for $25,000, or a subordinated note for $25,000. Nothing was discussed about common stock at that date at all.

MR. WALLER: Off the record a minute.

(Short discussion off the record.)

Q Of course, my question was directed, was there any reason why he didn't want to have a higher percentage of the common stock, he could have made a capital contribution and received a higher percentage than his fifty per cent that he had at that time with Mr. Bradley. That is the way the question was really intended. Do you see what I mean?

A Yes. Now, I follow you. The reason from that angle Bradley wanted to maintain in the equity of the Company a fifty-fifty basis with me, see.

Q Well now, is this a fair statement, Mr. Davis: That you consider that the business reason for the redemption in 1963 was really—resulted really from the business reason that required you to put up $25,000 in 1945?

A I don't quite follow that.

Q Well, let me try to rephrase it. In other words, as I understand, Mr. Davis, you're saying there was a business reason now for you to redeem your stock from the corporation in 1963. Is that fair?

A Well, what do you mean by "business reason" [fol. 10] there?

Q Just a corporate business reason. In other words, if you were just a corporate executive and weren't a shareholder, looking at it from the corporate viewpoint?

A Well, my whole thinking on the whole thing was based on the fact that I put this in, was required to put it in in order to get a loan of $95,000?

Q Now, this was in 1945?

A '45, with the understanding that I could withdraw this amount, that it would be redeemed, paid off by the corporation after the loan was paid.

Q So the business reason was really in 1945, and that reason was simply that you had to have an additional $25,000—

A In order to get the loan.

Q —to get the loan?

A In order to get the loan. We would not have gotten the loan had we not done it, and when that part of the whole transaction was completed—

MR. LITTLE: Well, I don't think I have any other questions.

MR. WALLER: Nothing further, Mr. Davis. Thank you, sir.

And further this deponent sayeth not.

(Signature waived)

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UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

CROSS-MOTION FOR SUMMARY JUDGMENT

(Filed May 10, 1967)

The defendant, through its attorney, Gilbert S. Merritt, Esquire, United States Attorney, for the Middle District of Tennessee moves the Court, pursuant to Rule 56 of the Federal Rules of Civil Procedure for summary judgment in the defendant's favor on the grounds that there is no genuine issue as to any material fact, and that the defendant is entitled to a judgment as a matter of law. This motion is based upon:

(a) Pleadings.

(b) Affidavit of Maclin P. Davis taken on October 5, 1966, and attached to the plaintiffs' motion for summary judgment (with the exception noted in the affidavit of H. Stennis Little, Jr., which is attached hereto).

(c) The affidavit of Lee Davis taken on October 18, 1966, which is attached to the plaintiffs' motion for summary judgment.

(d) The affidavit of H. Stennis Little, Jr., which is attached hereto and made a part hereof.

(e) The defendant's brief which is attached hereto and made a part hereof.

/s/ KENT SANDIDGE, III
Assistant United States Attorney

* * * *

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

AFFIDAVIT

(Filed May 10, 1967)

CITY OF WASHINGTON)
) ss:
DISTRICT OF COLUMBIA)

Before me came and appeared H. Stennis Little, Jr., who, being duly sworn, stated:

Affiant is an attorney employed by the United States Department of Justice and has been assigned the responsibility for the handling of this captioned case; he has in his possession the files maintained by the Commissioner of Internal Revenue with respect to the income tax return filed on behalf of plaintiffs, together with files maintained by the Department of Justice with respect to this captioned case.

1. This affidavit is filed in accordance with Rule 56(e) of the Federal Rules of Civil Procedure and takes exception to one statement made in the affidavit of Maclin P. Davis. The statement made on page 2 of the affidavit maintains that $25,000 was to be acquired as additional working capital and that such amount was to be obtained either by the sale of preferred stock or by the issuance of a subordinated deferred note. This statement was believed to have been made inadvertently by Mr. Davis and affiant no longer believes that Mr. Davis maintains that preferred stock or a subordinated deferred note were the only means whereby the $25,000 in working capital could be obtained. The affidavit of Lee Davis and the deposition of Mr. Maclin P. Davis, taken pursuant to the Federal Rules of Civil Procedure, indicate that the $25,000 of working capital could have also been obtained by the issuance of common stock. This is the position that was taken on the brief which was submitted by the

taxpayers to support their motion for summary judgment.

2. The names of Mr. and Mrs. Davis's children are: Maclin P. Davis, Jr. and Edith Davis Whitman (the names have not been previously presented into the record).

3. True copies of the Tennessee Foundry & Machine Co., Inc.'s tax returns for the fiscal years ended March 31, 1961, 1962, 1963, 1964 and 1965 are attached to this affidavit as exhibits 1, 2, 3, 4, and 5, respectively.

4. True copies of original and amended income tax returns for the year 1963 are attached to this affidavit as exhibits 6 and 7 respectively.

/s/ H. STENNIS LITTLE, JR.
H. STENNIS LITTLE, JR.
Attorney
Department of Justice
Washington, D.C. 20530

* * * *

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

AFFIDAVIT

(Filed July 24, 1967)

STATE OF TENNESSEE)
)
COUNTY OF DAVIDSON)

Maclin P. Davis, Jr., being first duly sworn, deposes and says:

1. I am a director, stockholder and secretary of Tennessee Foundry & Machine Company. I have been a director of that corporation since 1950. I was Vice President of the corporation from 1950 until 1964 and have been Secretary of the corporation since 1962.

2. The outstanding stock of said corporation consists of 1,000 shares of common stock. My father, Mr. Maclin P. Davis, my mother, Mrs. Edith U. Davis, my sister, Mrs. Harold B. Whiteman, and I own 250 shares each of the common stock and are the only stockholders of this corporation. My parents have another daughter, Mrs. Penn Owen, Jr., who does not own any stock in the corporation. My mother and father each have owned 250 shares of the common stock since 1945 when the corporation was formed. My sister, Mrs. Whiteman, and I have each owned 250 shares since 1959. This stock was purchased by my father from Mr. E. R. Bradley and later given to us.

3. I am 41 years of age and married and have three children, ages 13 years, 10 years, and 8 months. My wife and children and I live in Davidson County, Tennessee, in our own home. I have not resided in my father's home since 1953. I have been engaged in the practice of law in Nashville, Tennessee, since 1950 and have not been dependent upon my father since prior to that time.

4. My sister, Mrs. Whiteman, is 42 years of age and resides in New York, New York, with her husband and three children, whose ages are approximately 18 years, 16 years, and 14 years. Mrs. Whiteman has been married since 1946 and has not lived at my father's home nor been dependent upon him since that time. Mrs. Whiteman has never been a director or officer of the corporation.

5. I have read the affidavit of my father, Mr. Maclin P. Davis, dated October 5, 1966, and filed in support of plaintiffs' motion for summary judgment in this case and have also read his discovery deposition. All the facts stated in my father's affidavit and testified to in his deposition are in accordance with either my actual knowledge or with information which I had received prior to the time, in 1965, a revenue agent adjusted the 1963 income tax liability of my father and mother by treating the redemption price of the corporation's preferred stock as a dividend.

6. It has been my understanding since 1950 that my father's preferred stock could not be retired until the company's RFC loan was paid off. When my father's preferred stock was redeemed on October 1, 1963, the RFC loan had been paid off and the corporation was in a financial position to redeem the stock. 1963 was the first time these conditions had been met. It was considered by the company's directors and its auditor, Mr. John Glenn, Jr., that it was to the company's advantage to redeem the stock at that time because this $25,000 of additional capital was no longer needed and the redemption of the preferred stock eliminated the 6% cumulative dividend of $1,500 per annum. The common stock dividends paid by the company for the fiscal years ending on March 31 from 1961 through 1967 were as follows:

Year	Common Stock Dividends
1961	1,000
1962	2,000
1963	2,000
1964	2,000
1965	6,500
1966	8,000
1967	8,000

This affidavit is made by me in support of plaintiffs' motion for summary judgment and in opposition to defendant's cross-motion for summary judgment.

/s/ MACLIN P. DAVIS, JR.

* * * *

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

AFFIDAVIT

(Filed July 24, 1967)

STATE OF TENNESSEE)
)
COUNTY OF DAVIDSON)

William Waller, being first duly sworn, deposes and says:

The affidavit of H. Stennis Little, Jr. in this case makes the following statement: "The affidavit of Lee Davis and the deposition of Mr. Maclin P. Davis, taken pursuant to the Federal Rules of Civil Procedure, indicate that the $25,000 of working capital could have also been obtained by the issuance of common stock." It is true that so far as the RFC was concerned, it was immaterial whether preferred stock or common stock was issued. However, Mr. Bradley, who received 50% of the common stock in exchange for property, was unable or unwilling to put up cash for additional capital, but at the same time insisted on retaining 50% of the voting power. For this reason, no consideration was ever given to providing the additional $25,000 of capital except by subordinated debentures or preferred stock.

This affidavit is made by the undersigned rather than by Mr. Davis because he is in Europe and is unavailable. The undersigned acted as legal counsel in the organization of the corporation and was familiar with the facts stated.

/s/ WILLIAM WALLER

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UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

MEMORANDUM

(Filed September 15, 1967)

This civil action was instituted by Maclin P. Davis[1] (hereinafter the taxpayer) against the United States of America (hereinafter the government) for a refund of income taxes and interest paid in response to an assessment by the Internal Revenue Service. The controversy arises out of a redemption at par of certain shares of preferred stock owned by taxpayer which the Internal Revenue Service treated as a dividend distribution to which § 301 of the Internal Revenue Code applies. Taxpayer maintains that this distribution constituted a redemption "not essentially equivalent to a dividend" within the meaning of § 302(b)(1) and thus qualifies as a distribution "in exchange for the stock" under § 302(a). The cause is now before the Court on the motions of both parties for summary judgment.

I

In April, 1945, taxpayer and E. B. Bradley organized the Tennessee Foundry and Machine Company (hereinafter the corporation) for the purpose of manufacturing steel castings. Prior to incorporation, taxpayer had entered into negotiations with the Reconstruction Finance Corporation (hereinafter the RFC) and the First American National Bank of Nashville, Tennessee, for the purpose of obtaining a $95,000 loan to the corporation. The prospective lenders agreed to make the loan if certain terms and conditions were met. The main prerequisite was that the incorporators provide the corporation with an additional $25,000 working capital either by making

[1] Edith U. Davis, taxpayer's wife, is a party to the suit because a joint return was filed.

a loan evidenced by a subordinated deferred note or by purchasing preferred or additional common stock.

Bradley, who had received 50 percent of the common stock in exchange for property transferred to the corporation, was unable or unwilling to invest additional capital but insisted on retaining 50 percent of the voting power. Consequently, the only methods of raising this additional capital considered by taxpayer were purchasing preferred stock or taking subordinated debentures in exchange for a loan. Taxpayer decided the former was preferable, giving as his reason that this would be more desirable than an outright loan from a balance sheet standpoint. Taxpayer contends that the sole purpose of this transaction was to enable the corporation to obtain the RFC loan, and that all concerned were in agreement that this stock would be held only until the loan was repaid at which time it would be redeemed.

Upon approval of the loan application by the RFC, taxpayer purchased 1,000 shares of 6 percent preferred stock at par value of $25 per share as authorized by the charter of the corporation. Thus, as of the date of incorporation or shortly thereafter, the outstanding shares were held as follows:

Shareholder	Common - %	Preferred - %
E. B. Bradley	500 - 50	
Maclin P. Davis	250 - 25	1,000 - 100
Edith U. Davis	250 - 25	

Due to financial difficulties encountered by the corporation, the loan was refinanced in 1946. The principal was increased to $110,000 and the maturity date was extended.

In 1952, taxpayer purchased the 500 shares of common stock owned by Bradley and in 1959 he transferred 250 of these shares to his son, M. P. Davis, Jr., and 250 shares to his daughter, Edith D. Whiteman. Consequently, at the time of the redemption in question the ownership of the outstanding shares of the corporation was as follows:

Shareholder	Common - %	Preferred - %
Maclin P. Davis	250 - 25	1,000 - 100
Edith U. Davis	250 - 25	
M. P. Davis, Jr.	250 - 25	
Edith D. Whiteman	250 - 25	

The original loan agreement provided that, as long as any part of the loan was outstanding, no dividends could be paid without first obtaining the prior written consent of the Bank and the RFC. In 1960, permission was granted to declare dividends on the outstanding stock. Consequently, semi-annual dividends in the amount of $750 were paid on the preferred stock beginning on October 5, 1960.

On September 23, 1963, after final payment on the loan had been made,[2] the board of directors of the corporation resolved to redeem the preferred stock by accepting taxpayer's offer to transfer these shares in exchange for the sum of $25,000. On October 1, 1963, taxpayer surrendered the certificate representing the stock and was paid $25,000.

Taxpayer, characterizing the distribution as a return of capital, did not report this amount as income in his 1963 return on the theory that no gain had been realized because his basis in the preferred stock was equal to the amount received. After an audit, the Internal Revenue Service concluded that the amount received pursuant to the redemption constituted a distribution of property within the meaning of § 301 and thus was essentially equivalent to a dividend and taxable as ordinary income. Upon the Commissioner's denial of a claim for a refund, this action was commenced.

II

The general rule of § 301 is that a distribution by a corporation to a shareholder with respect to his stock is treated as a dividend to the extent of the corporation's earnings and is includable in the recipient's gross in-

[2] Final payment was made June 1, 1963.

come, unless the distribution can be brought within an exception to this rule. The relevant exception here is found in the provisions of § 302 dealing with distributions in redemption of stock.

Under § 302(a), corporate redemptions are to be treated as distributions in part of full payment for the stock redeemed if the transaction comes within one of the four subdivisions of § 302(b). Section 302(b)(1) provides that a redemption which "is not essentially equivalent to a dividend" falls within the protective scope of § 302(a). Thus, if a redemption qualifies under § 302(b)(1), the distribution is treated as a payment in exchange for stock under § 302(a) with the result that it is not includable in gross income as a dividend and any amount realized on the redemption is entitled to capital gains treatment.

The determinative issue, therefore, is whether the amount received by taxpayer pursuant to the redemption in question is "essentially equivalent to a dividend" and thus taxable as ordinary income.

III

However, before the basic issue of dividend equivalency can be decided, the preliminary question of the bearing of the § 318(a) family attribution rules upon § 302(b)(1) must be resolved.

The government contends that the attribution rules are automatically applicable on the ground that § 302(c)(1) specifically provides that § 318(a) "shall apply in determining the ownership of stock for the purposes of this section." If the attribution rules are applicable, taxpayer must be regarded as the constructive owner of all of the outstanding stock of the corporation and the redemption must be characterized as basically pro rata.

Taxpayer, in assuming a contrary position, reasons that the language of § 318(a), which provides that it is applicable only to "those provisions of this subchapter to which the [attribution] rules . . . are expressly made applicable," precludes applicability to § 302(b)(1) because § 318(a) is relevant to § 302(b) only for the purpose of determining stock ownership and § 302(b)(1),

unlike the other subdivisions of § 302(b), does not expressly refer to stock ownership, but rather speaks in terms of the effect of the redemption. Thus, it is argued that the "non-fact" of constructive ownership is not properly a part of the factual inquiry into the effect of the distribution required by § 302(b)(1).

Taxpayer further asserts that the legislative history of § 302(b)(1) also precludes automatic applicability of the attribution rules. In support of this contention, taxpayer argues that § 302(b)(1) was intended to incorporate existing law as to whether a redemption is essentially equivalent to a dividend[3] and that under § 115(g) of the 1939 Code the ownership of the remaining stock was only one element in a primarily factual determination.

Although taxpayer's contentions are not without some persuasiveness,[4] the Court is of the opinion that the weight of authority supports the government's position that the attribution rules apply under § 302(b)(1). See, e.g., *Commissioner* v. *Berenbaum*, 369 F. 2d 337 (10th Cir. 1966); *Levin* v. *Commissioner*, 47 T.C. 258 (1966); Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, 292 (2d Ed. 1966). For the purpose of determining dividend equivalency, therefore, ownership of all of the outstanding common stock of the corporation is attributable to the taxpayer with the effect that the distribution was essentially pro rata. Consequently, corporate ownership cannot be regarded as affected in any substantial way by the transaction.

However, dividend equivalency does not necessarily follow from the Court's conclusion that the attribution rules are applicable under § 302(b)(1).

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[3] Sen. Rep. No. 1622, 83d Cong. 2d Sess. 44 (1954): "In lieu of the approach in the House bill, your committee intends to revert in part to existing law by making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, except where it is specifically provided otherwise, upon a factual inquiry."

[4] Cf. Lewis v. Commissioner, 47 T.C. 129 (1966).

IV

While the words "not essentially equivalent to a dividend" are not further defined by Congress, it is clear that the intent of Congress in enacting § 302(b)(1) was that the "test for determining whether a redemption was 'essentially equivalent to a dividend' should be the same as the test utilized in interpreting and applying the same words in § 115(g)(1) of the 1939 Code." *Kerr* v. *Commissioner*, 326 F. 2d 225, 230 (9th Cir. 1964). Some attention, therefore, must be given to the tests developed under the 1939 Code in order to ascertain present standards of administering § 302(b)(1).

Prior to *Flanagan* v. *Helvering*, 116 F. 2d 937 (D.C. Cir. 1940), it was generally held that the applicability of § 115(g) to a stock redemption was a factual question in which the basic criterion was whether the transaction was motivated by a legitimate corporate business purpose as distinguished from mere tax avoidance.[5] However, in *Flanagan*, at 939-940, the Court took the position that "the net effect of the distribution, rather than the motives and plans of the taxpayer or his corporation, is the fundamental question in administering § 115(g)." Under this objective test, business purpose as the basic criterion for the applicability of § 115(g) was replaced by an analysis of the net effect of the redemption transaction. However, many of the courts which purported to follow the net effect test, in effect, expanded that test to include inquiry into the possibility of an underlying legitimate business motive. See, e.g., *Boyle* v. *Commissioner*, 187 F. 2d 557 (3rd Cir. 1951), cert. denied 342 U.S. 817; *Commissioner* v. *Snite*, 177 F. 2d 819 (7th Cir. 1949); *Hirsh* v. *Commissioner*, 124 F. 2d 24 (9th Cir. 1941).

In *Keefe* v. *Cote*, 213 F. 2d 651 (1st Cir. 1954), the Court had the alternative of following the net effect test as set forth in *Flanagan*, *supra*, or as broadened by subsequent cases which inquired into the motive under-

[5] This test is generally met when a corporation has effected a preconceived legal plan to improve the corporation's standing as opposed to a plan which primarily benefits the stockholders.

lying the transaction. The taxpayer, who owned in excess of 90 percent of the stock of a closely held corporation, had been issued the redeemed stock in exchange for a note previously given him in settlement of salaries due. When the stock was subsequently redeemed at an amount representing its appreciated value, the taxpayer argued that the increment was entitled to capital gains treatment. The Court upheld this contention, holding that the redemption was a step in carrying out a legitimate corporate purpose.[6]

In the opinion of the Court, *Keefe* v. *Cote*, *supra*, is to be read as reviving the "proposition that if there is a legitimate corporate purpose for the acquisition of stock by the issuing corporation, it [the redemption] is not essentially equivalent to the distribution of a taxable dividend." *United States* v. *Fewell*, 255 F. 2d 496, 500 (5th Cir. 1958).

Thus, while the net effect of the distribution is generally regarded as the most important consideration in determining dividend equivalency, there are two positions within this rule which, for purposes of convenience, may be described as the "strict" and the "flexible" net effect tests. Under the former, the ultimate result of the distribution is evaluated without regard to any underlying business purpose, while, under the latter, motivation may be properly considered in ascertaining the ultimate effect.

Upon consideration, the Court is of the opinion that the "flexible" net effect test is the preferable method of ascertaining § 302(b)(1) dividend equivalency. Consid-

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[6] Although taxpayer owned 93.9 percent of the stock and the distribution was therefore essentially pro rata, the Court did not regard the fact that the objective result of the transaction was essentially equivalent to a dividend as determinative. Rather, the Court focused on the taxpayer's testimony that the stock had been issued to him for the purpose of improving the corporate credit standing and with the understanding that the stock would be redeemed whenever it was convenient for the corporation to do so. The Court concluded that dividend equivalency was lacking on the grounds that the redemption was a part of the original transaction and that the improvement of the corporation's credit standing was a legitimate corporate business purpose.

ering the possibility of a justifying business purpose as a factor in this determination more clearly recognizes that the outcome will generally depend "upon the facts and circumstances of each case." Federal Income Tax Regulations, § 1.302-2(b). The question before the Court, therefore, is whether there is a legitimate business purpose underlying this distribution which is sufficiently compelling to overcome the objective fact that its pro rata nature "points to a tax avoidance scheme." *Ballenger* v. *United States*, 301 F. 2d 192, 199-200 (4th Cir. 1962).

While recognizing that there was a legitimate business purpose underlying the issuance of the preferred stock in 1945, the government maintains that there was no comparable justification for the redemption in 1963. This assertion is not well taken. In determining whether the instant case satisfies the "flexible" net effect test, it is not essential that the issuance and the redemption must have been motivated by distinct business purposes. Rather, it is sufficient if it can be found that "there was a corporate business purpose in issuing the shares and . . . that they were redeemed in carrying out that purpose." *Keefe* v. *Cote*, *supra*, at 657.

It is clear that the preferred stock was issued solely in order to provide the additional security required by the RFC as a precondition to making the initial $95,000 loan. Based on the facts as set forth in the record, the Court is of the opinion that it was understood that the corporation would subsequently redeem these shares when the RFC loan was repaid and that the redemption in 1963 was the final step in carrying out the original purpose of obtaining this loan. Of course, at the time the preferred stock was issued and its redemption planned, such redemption would not have been pro rata. The subsequent acquisition of Bradley's stock holdings by taxpayer, making the redemption distribution essentially pro rata because of the § 318(a) attribution rules, neither impairs the legitimacy of the purpose underlying the issuance of the preferred stock nor alters the fact that the redemption was simply the final step taken in completion of this purpose.

Accordingly, the Court holds that the amount received by taxpayer in exchange for his 1,000 shares of preferred stock was not essentially equivalent to a dividend within the meaning of § 302(b)(1) of the Code and must, therefore, be treated as a distribution in part or full payment for the stock redeemed, under § 302(a).

An appropriate order will be submitted within twenty (20) days.

/s/ FRANK GRAY, JR.
United States District Judge

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

ORDER

(Filed October 5, 1967)

This action came on for hearing before the Honorable Frank Gray, Jr. upon motions for summary judgment supported by affidavits filed by both parties and, upon consideration thereof, the Court having rendered and filed its Memorandum on September 15, 1967,

It is ORDERED and ADJUDGED that the plaintiffs recover of the defendant the sum of $12,910.51 together with interest thereon at the rate of six percent per annum from and after November 15, 1965, and their costs of this action.

/s/ FRANK GRAY, JR.
Judge

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

MOTION FOR REHEARING

(Filed October 9, 1967)

The defendant, the United States of America, by its attorney, Gilbert S. Merritt, Esquire, United States Attorney for the Middle District of Tennessee, moves the Court for a rehearing in the above-entitled case for the reason that the Court's decision of September 15, 1967, is contrary to the cases of *Ballenger* v. *United States*, 301 F. 2d 192 (C.A. 4th) and *Commissioner* v. *Berenbaum*, 369 F. 2d 337 (C.A. 10th). Furthermore, it is respectfully submitted that the Court's decision allows for tax avoidance planning in setting up newly formed corporations. An oral hearing on this matter is requested.

GILBERT S. MERRITT
United States Attorney

By: /s/ KENT SANDIDGE, III
Assistant United States Attorney

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UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

[Caption Omitted]

ORDER

(Filed October 19, 1967)

This case was called October 19, 1967, for hearing on the motion for rehearing heretofore filed by the defendant. After hearing argument of counsel for the defendant in this regard, the Court was of the opinion that the motion was not well taken.

Accordingly, it is ORDERED that the motion for rehearing heretofore filed by the defendant be, and the same is hereby, denied.

/s/ FRANK GRAY, JR.
United States District Judge

IN THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 18487

MACLIN P. DAVIS AND EDITH U. DAVIS,
PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

On Appeal from the United States District Court for the Middle District of Tennessee

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Decided March 27, 1969

Before: O'SULLIVAN and CELEBREZZE, *Circuit Judges* and MCALLISTER, *Senior Circuit Judge.*

CELEBREZZE, Circuit Judge. The Government appeals a judgment of the United States District Court for the Middle District of Tennessee granting Taxpayer's [1] claim for refund of federal income taxes. The cause was heard on motions for summary judgment filed by both parties. On denial of its motion for rehearing the Government perfected this appeal. The question before us is whether a corporate distribution to Taxpayer, in redemption of all his preferred stock in the Corporation, was essentially equivalent to a dividend under Section 302(b)(1) of the Internal Revenue Code of 1954.[2]

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[1] Appellees filed a joint return. The designation "Taxpayer" throughout this opinion, however, shall refer to Maclin P. Davis.

[2] "Sec. 302. Distributions in Redemptions of Stock.

"(a) General Rule.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated

In 1945, Taxpayer and one Bradley organized the Tennessee Foundry & Machinery Company (hereinafter Corporation) to manufacture steel castings. In exchange for equipment transferred to the Corporation, Bradley and Taxpayer each received fifty percent of its common stock. Prior to incorporation, Taxpayer had begun negotiations with the Reconstruction Finance Corporation (hereinafter RFC) for the purpose of obtaining a $95,000 loan to the Corporation. RFC agreed to make the loan on the condition that the incorporators provide the Corporation with additional working capital in the amount of $25,000. Bradley insisted on retaining his fifty percent of the voting power but was unwilling to invest any additional capital. In order to meet the demand of RFC, Taxpayer contributed the $25,000 in exchange for one hundred shares of six percent non-voting preferred stock with a par value of $25 per share. Taxpayer contended and the District Court found that the sole purpose of the transaction was to enable the Corporation to obtain the RFC loan and that the preferred stock was to be redeemed when the loan was repaid. Thus, on the date of incorporation the capital structure of the Corporation was as follows:

	Common—%	Preferred—%
Bradley	500 - 50	
Taxpayer	250 - 25	1,000—100%
Taxpayer's Wife	250 - 25	

In 1952, Taxpayer purchased Bradley's common stock and in 1959 he transferred 250 shares to his son and 250 shares to his daughter. The original loan agreement provided that so long as part of the RFC loan was out-

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as a distribution in part or full payment in exchange for the stock.

"(b) Redemptions Treated as Exchanges.—

"(1) Redemptions not equivalent to dividends.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend."

standing, no dividends could be paid without obtaining the written consent of RFC. Such permission was granted in 1960 and semiannual dividends were paid beginning on October 5th of that year.

On June 1, 1963 the loan was paid off and on September 23, 1963 the Corporation voted to redeem Taxpayer's preferred stock. On October 1, 1963 this stock was redeemed for $25,000, the amount Taxpayer paid for it. On this date the capital structure of the Corporation, reflecting the prior purchase of Bradley's shares by Taxpayer, was as follows:

	Common—%	Preferred—%
Taxpayer	250 - 25	1,000
Wife	250 - 25	
Son	250 - 25	
Daughter	250 - 25	

The Commissioner contended that the $25,000 was "essentially equivalent to a dividend" within the meaning of Section 302(b)(1) of the Code, hence taxable as ordinary income under Section 301 of the Code.[3] The District Court held to the contrary and granted Taxpayer's claim for refund. We affirm the judgment of the District Court.

Section 302 of the Code provides capital gains treatment to corporate distributions made in redemption of stock. The transaction is treated as a sale or exchange of a capital asset and gain is realized to the extent that the distribution exceeds a taxpayer's cost basis for the stock. Here, Taxpayer received back his cost basis for the stock so he had no gain. On the other hand, corporate distributions amounting to dividends are includable in their entirety in gross income and taxed at ordinary rates. Where the question is whether a particular cor-

[3] Section 301(c) of the Code provides that gross income includes dividends. Section 316 of the Code defines a "dividend" generally as a distribution of property made by a corporation to its shareholders out of earnings and profits.

porate distribution is a redemption or dividend Section 302 provides several tests for determining the answer.[4] Since the Corporation was not liquidating its business and the stock redeemed was preferred stock with no voting rights, our inquiry is limited to Section 302(b)(1) which simply states the principle that a corporate distribution in exchange for stock is not a redemption if it is essentially equivalent to a dividend.[5]

We therefore look to the facts as found by the District Court to determine whether the distribution in issue was equivalent to a dividend. See *Ballenger* v. *United States*, 301 F. 2d 192 (4th Cir. 1962). The standard contained in Section 302(b)(1) calls for a factual resolution of the question and has been so used by the courts and the Commissioner. *Rheinstrom* v. *Commissioner*, 125 F. 2d 790 (6th Cir. 1942), cert. denied 317 U.S. 654; *Cobb* v. *Calan Court Co.*, 274 F. 2d 532 (5th Cir. 1960); *Colvin* v. *United States*, 175 F. Supp. 877 (S.D. Cal. 1959); Treasury Regulation 1.302-2(b). Our function on review is to determine whether the District Court applied the correct criteria to those facts. *Ballenger*, supra; but see *Pacific Vegetable Oil Co.* v. *Commissioner*, 251 F. 2d 682 (9th Cir. 1957) (dividend equivalency is mixed question of fact and law).

The purpose of the various tests in Section 302(b) of the Code is to prevent tax avoidance, more specifically, to prevent corporations from bailing out earnings to

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[4] Similar rules are contained throughout Code Sections 301-318 (distributions by corporations other than liquidating distributions) and Code Sections 331-346 (liquidating distributions.)

[5] By contrast, Subsections (2), (3), and (4) of Section 302(b) contain objective tests for determining whether the distribution was a redemption. Subsection (2) provides that substantially disproportionate distributions with respect to the shareholder are to be treated as redemptions under Section 302(a). By a limitation contained in that subsection, however, the shareholder must after the distribution end up with less than 50% of the total combined voting power in the corporation. Subsection (3) provides that a shareholder's stock is considered to be redeemed under Section 302(a) when he terminates his interest in the corporation. Subsection (4) deals with railroad corporations. This leaves for our consideration Subsection (1) of Section 302(b).

shareholders at favorable capital gains rates. To bring some objectivity to Section 302(b)(1), the Courts have established some guidelines which when applied to the facts of each case are calculated to determine whether a particular corporate distribution is in fact a dividend. Under the "strict net effect" test, if the taxpayer ends up in the same position after the distribution as he would have occupied had a dividend been declared, the net effect of the transaction is held to be the payment of a dividend. See, *e.g.*, *Commissioner* v. *Estate of Bedford*, 325 U.S. 283 (1945); *Levin* v. *Commissioner*, 385 F. 2d 521 (2d Cir. 1967). Applying the strict net effect test in the way that the Government urges, in 1963, Taxpayer—because of the attribution rules of Section 318[6] of the Code—would be considered as owning all of the common stock of the Corporation so the distribution to him in payment for his preferred stock was made pro rata on his common stock. The Government contends that a pro rata distribution by a corporation effecting no basic change in shareholder relationships is the hallmark of a dividend, therefore the payment to Taxpayer was "essentially equivalent to a dividend" and taxable as such. *Himmel* v. *Commissioner*, 388 F. 2d 815 (2d Cir. 1964); *Kerr* v. *Commissioner*, 326 F. 2d 225 (9th Cir. 1964) cert. denied 377 U.S. 963.

The District Court, however, looked to the entire transaction and applied the "flexible net effect" test. Under

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[6] Section 318(a)(1) makes Taxpayer the constructive "owner" of the common stock owned by his spouse and children. Since his spouse and children each owned 25% of the remaining 75% of the common stock of the Corporation, Taxpayer winds up with 100% of the common stock. Section 318(a) is made applicable to Section 302 generally by Subsection (c)(1) of Section 302. But whether the attribution rules apply specifically to Section 302(b)(1) has caused some controversy. See, *e.g.*, Comment, 47 Minn. Law Rev. 853, 867-70 (1963). The District Court held that they do apply to Section 302(b)(1). We agree to the extent that constructive ownership of stock may be used as a factor to determine whether the distribution in question is in reality a dividend. See Treas. Reg. 1.302-2(b). But, like the flexibility given to the strict net effect test, there may be situations where it would be unrealistic to apply the attribution rules in strict fashion, for instance in cases of family estrangement. *Levin* v. *Commissioner*, 385 F. 2d 521 (2d Cir. 1967); *Himmel* v. *Commissioner*, 338 F. 2d 815 (2d Cir. 1964).

this test, a business purpose for the redemption will temper the conclusiveness of a strict net effect result. See *Keefe* v. *Cote*, 213 F. 2d 651 (1st Cir. 1954). The Court looked to the point in time when Taxpayer contributed the $25,000 and found that the Corporation had always intended to redeem Taxpayer's preferred stock when the loan was paid off. We are aware that use of "business purpose" to mollify the rigors of the strict net effect test has been criticized, see, *e.g.*, *Levin* v. *Commissioner*, 385 F. 2d 521 (2d Cir. 1967), even by the First Circuit which purports to follow it. *Bradbury* v. *Commissioner*, 298 F. 2d 111 (1st Cir. 1962). Many courts, however, give it some weight. See *United States* v. *Fewell*, 255 F. 2d 496 (5th Cir. 1958); *Commissioner* v. *Berenbaum*, 369 F. 2d 337 (10th Cir. 1966); *Phelps* v. *Commissioner*, 247 F. 2d 156 (9th Cir. 1957); *Colvin* v. *United States*, 175 F. Supp. 877 (S.D. Cal. 1959); *Estate of Golwynne*, 26 T.C. 1209 (1956). In any event, the "strict net effect" test and the "flexible net effect" test complement each other in this respect: to the extent that the facts show a business purpose for the redemption there is an absence of the proscribed tax avoidance purpose to bail out dividends at favorable tax rates. See *Ballenger* v. *United States*, 301 F. 2d 192, 198 (4th Cir. 1962).

The Government concedes that there would be no issue of dividend equivalency here had the Corporation redeemed Taxpayer's preferred stock while Bradley owned fifty percent of the Corporation's common stock. A redemption of any of Taxpayer's preferred stock at such time would not have been a pro rata distribution on the Corporation's common stock. Nevertheless, armed with the strict net effect test the Government contends that Taxpayer's subsequent acquisition by way of attribution under Section 318(a) of the Code of one hundred percent control of the Corporation converted the distribution to him in payment for his preferred stock into a dividend paid pro rata on the common stock. To expand upon the Government's argument, Taxpayer was precluded from withdrawing his $25,000 investment intact because his decision to buy out Bradley's interest and acquire control of the Corporation converted what would have been

a straight stock redemption into a tax-avoidance scheme to bail out corporate earnings. We do not believe Congress intended that Section 302 of the Code should work such a harsh result especially since the primary purpose of capital gains treatment is to encourage individuals to risk capital for investment purposes. Although closely-held corporations call for close scrutiny under the tax law, we will not, under the facts and circumstances of this case, allow mechanical attribution rules to transform a legitimate corporate transaction into a tax avoidance scheme.

A transaction involving Section 306 of the Code illustrates the converse situation. Under that Section, preferred stock or its equivalent is treated for income tax purposes as a cash dividend where the preferred stock was originally distributed as a stock dividend pro rata on the outstanding common stock. Section 306(c)(1)(A) Internal Revenue Code of 1954. Under Section 305 of the Code stock dividends are not taxable. When Section 306 preferred stock is sold or redeemed, the payment for it is taxable at ordinary income rates unless the shareholder has at the same time terminated his interest in the corporation.[7] Before the enactment of Section 306, the use of the "preferred stock bail out" was a popular tax avoidance device and Section 306 was intended to eliminate it. Section 306 stock, however, does not lose its cash dividend character if the holder disposes of all or part of his common stock. Section 302(b)(3); cf. *Himmel* v. *Commissioner*, 338 F. 2d 815 (2d Cir. 1964). Likewise, Taxpayer's preferred stock did not become a cash dividend coverup even if the attribution rules are applied from the date he bought Bradley's common stock.

The facts of this case demand that substance win over form and that the entire transaction control the tax effect of the stock redemption in issue. As the District Court stated:

> "The subsequent acquisition of Bradley's stock holdings by taxpayer, making the redemption distribu-

[7] Section 306 adopts the termination criterion of Section 302(b)(3) of the Code. See footnote 5, supra.

> tion essentially pro rata because of the § 318(a) attribution rules, neither impairs the legitimacy of the purpose underlying the issuance of the preferred stock [to provide additional security required by RFC] nor alters the fact that the redemption was simply the final [contemplated] step taken in completion of this purpose."

We conclude that the District Court was, under the facts and circumstances in this case, correct in holding that the redemption by the Corporation of Taxpayer's preferred stock was a distribution made in exchange for his stock and not a distribution that was "essentially equivalent" to a dividend.

Affirmed.

IN THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 18,487

MACLIN P. DAVIS AND EDITH U. DAVIS,
PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Before: O'SULLIVAN and CELEBREZZE, *Circuit Judges*, and MCALLISTER, *Senior Circuit Judge.*

JUDGMENT

Appeal from the United States District Court for the Middle District of Tennessee

This cause came on to be heard on the record from the United States District Court for the Middle District of Tennessee and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby affirmed.

It is further ordered that Plaintiff-Appellee recover from Defendant-Appellant the costs on appeal, as itemized below, and that execution therefor issue out of said District Court.

Entered by order of the Court.

CARL W. REUSS
Clerk

Filed March 27, 1969.

SUPREME COURT OF THE UNITED STATES

No. 282, October Term, 1969

UNITED STATES, PETITIONER

v.

MACLIN P. DAVIS, ET UX.

ORDER ALLOWING CERTIORARI—Filed October 13, 1969

The petition herein for a writ of certiorari to the United States Court of Appeals for the Sixth Circuit is granted, and the case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1969 366876 284

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In the Supreme Court of the United States

OCTOBER TERM, 1969

No.

UNITED STATES OF AMERICA, PETITIONER

v.

MACLIN P. DAVIS AND EDITH U. DAVIS

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINION BELOW

The opinion of the district court (R. 33a–42a) [1] is reported at 274 F. Supp. 466. The opinion of the court of appeals (App. A, *infra*, pp. 11–19) is not yet reported.

JURISDICTION

The judgment of the court of appeals was entered on March 27, 1969 (App. B, *infra*, p. 21). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

[1] "R" refers to the printed record in the court of appeals entitled "Appendix B to Brief for the Defendant-Appellant".

QUESTION PRESENTED

Whether the redemption by a corporation of all of its preferred stock from the respondent, who was also the actual or constructive owner of all of the corporation's common stock, resulted in a corporate distribution which was essentially equivalent to a dividend within the scope of Section 302(b)(1) of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 301, 302, 316 and 318 of the Internal Revenue Code of 1954 and Section 1.302–2 of the Regulations thereunder are set forth in Appendix C. *infra,* pp. 23–27.

STATEMENT

Respondent and E. B. Bradley organized Tennessee Foundry and Machine Company in 1945. Prior thereto, respondent had entered into negotiations for a $95,000 loan to the corporation. The prospective lenders, the Reconstruction Finance Corporation and a bank, had agreed to make the loan only if respondent and Bradley provided the corporation with an additional $25,000 of working capital either by making a loan evidenced by a subordinated deferred note or by purchasing preferred or additional common stock. Bradley was unable or unwilling to invest additional capital but insisted on retaining 50 per cent of the voting power. As a result, the only methods of raising the additional capital considered were that respondent would either purchase preferred stock or take subordinated debentures in exchange for a loan. Upon approval of the loan application by the Reconstruction

Finance Corporation, respondent purchased 1,000 shares of six percent preferred stock at a par value at $25 per share. Thus, on the date of incorporation or shortly thereafter, respondent held all the preferred stock, he and his wife held 50 percent of the 1,000 shares of common stock and Bradley held the other 50 percent of the common (R. 33a–34a.)

In 1952 respondent purchased Bradley's 500 shares of common stock, and in 1959 transferred 250 of these shares to his son, M. P. Davis, Jr., and 250 shares to his daughter, Edith D. Whiteman. As a consequence, respondent, his wife, daughter and son held all the common stock and respondent held all the preferred stock (R. 35a).[2]

On September 23, 1963, after final payment on the loan had been made, the corporation's board of directors resolved to redeem the preferred stock by accepting respondent's offer to transfer these shares in exchange for the sum of $25,000. On October 1, 1963, respondent surrendered the certificate representing the stock and was paid $25,000. (R. 35a.)

For income tax purposes respondent treated the $25,000 as a sale of preferred stock resulting in no gain to him because his basis for the stock was $25,000. Upon audit, the Internal Revenue Service determined that the $25,000 was a distribution that was essentially equivalent to a dividend and therefore

[2] "Respondent" refers to Maclin P. Davis. His wife is a party because joint returns were filed for the tax year in question. Under Section 318(a) of the Code, the respondent is treated as owning all of these shares. See p. 9, below.

taxable as ordinary income.[3] Respondent paid the resulting deficiency and later instituted this suit for refund.[4] (R. 36a.) The district court decided the issue in favor of the respondent and the Sixth Circuit affirmed. (R. 36a–42a, App. A, *infra*, pp. 11–20.)

REASONS FOR GRANTING THE WRIT

The decision below is part of a multi-dimensional conflict in the interpretations the courts of appeals have given Section 302(b)(1) of the Internal Revenue Code of 1954. The issue is a continually recurring one in the administration of the Code provisions which affect closely held corporations. This court must resolve the conflict if confusion in this area of the tax law is to be eliminated and if even-handed treatment of similarly situated taxpayers is to be achieved.

1. Sections 301 and 316 of the Internal Revenue Code of 1954 require that distributions of corporate property to shareholders be treated as dividends, taxable at ordinary income rates to the extent of accumulated corporate earnings and profits, unless the distribution can be brought within some specific statutory exception. See *e.g., Commissioner* v. *Gordon,* 391 U.S. 83, 89. The ultimate question here is whether Tennessee Foundry's

[3] Under the Service's view of the transaction, respondent's basis in his preferred stock should now be reflected by an appropriate adjustment in the basis of petitioner's common stock. See Regulations on Income Tax (1954 Code) § 1.302–2(c) and the examples thereunder.

[4] There is no claim that the redemption of respondent's preferred stock resulted in a contraction of the business or in any other fashion qualified for capital gains treatment as a partial liquidation under Section 346 of the Code. The only distribution was of cash out of earnings.

redemption of respondent's preferred stock comes within the exception defined in Section 302 of the Code (App. C, *infra*, pp. 23–24).

Section 302(a) states that a corporate stock redemption "shall be treated as a distribution * * * in exchange for the stock"—that is, shall be given capital treatment—if the redemption qualifies under one of the four subparagraphs of Section 302(b). This case is concerned only with Section 302(b)(1), which provides that a redemption shall be treated as a distribution in exchange for stock "if the redemption is not essentially equivalent to a dividend."[5]

The question presented here is, in substance, the extent to which the "business purpose" attending the redemption is to be considered in determining whether the redemption is essentially a dividend. The position of the Commissioner of Internal Revenue is that business purpose is immaterial, and that there is dividend equivalence if the redemption is pro rata to each shareholder's interest in a corporation.

2. With the decision below, seven courts of appeals have considered the issue which this case presents. The result has been at least four distinct attitudes towards the significance to be accorded the purpose of a redemption. Only the Second Circuit has accepted with-

[5] The other three categories of qualifying redemptions are those (Section 302(b)(2)) that are "substantially disproportionate" to the shareholder's interest in the corporation; a redemption (Section 302(b)(3)) of all of the shareholder's stock; and a redemption (Section 302(b)(4)) of the stock of certain railroad corporations. See, generally, Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed. 1966) 279–300.

out qualification the Commission's position which has become known as the "strict" net effect test. See *McGinty* v. *Commissioner*, 325 F. 2d 820 (C.A. 2); *Hasbrook* v. *United States*, 343 F. 2d 811 (C.A. 2); *Levin* v. *Commissioner*, 385 F. 2d 521 (C.A. 2). Two other circuits, the Ninth and Tenth, apply a so-called "flexible" net effect test, under which business purpose is considered as a factor militating against dividend equivalence. *Kerr* v. *Commissioner*, 326 F. 2d 225 (C.A. 9); *Tabery* v. *Commissioner*, 354 F. 2d 422 (C.A. 9); *Commissioner* v. *Berenbaum*, 369 F. 2d 337 (C.A. 10). The Eighth Circuit seems to have a third approach, which treats the question of dividend equivalence as entirely one of fact[6] while at the same time holding that a bona fide business purpose does not require a holding for the taxpayer. See *Heman* v. *Commissioner*, 283 F. 2d 227 (C.A. 8). The Fifth Circuit has expressed a similar view as to the significance of business purpose. *United States* v. *Fewell*, 255 F. 2d 496, 500 (C.A. 5).

It is unclear what rule applies in the First and Fourth Circuits. The First Circuit first adopted the "flexible" net effect test but now appears to be working toward the Second Circuit's view. Compare *Keefe* v. *Cote*, 213 F. 2d 651 (C.A. 1), with *Bradbury* v. *Commissioner*, 298 F. 2d 111 (C.A. 1). The Fourth Circuit, in contrast, first seemed to approve the "strict" net effect test, although in dicta, but in a more recent decision has apparently changed its position. Compare *Ballenger* v. *United States*, 301 F. 2d

[6] Compare the Ninth Circuit's statement in *Kerr* (326 F. 2d at 229) and *Tabery* (354 F. 2d at 427), that the question is "a mixed question of law and fact, if not purely a conclusion of law." This problem is not involved in this case.

192 (C.A. 4), with *Commissioner* v. *Estate of Antrim*, 395 F. 2d 430 (C.A. 4).

3. The decision of the Sixth Circuit in this case reflects yet another approach. While purporting to adhere to the "flexible" net effect test, the court did not find or rest on any business purpose attending the redemption of respondent's stock in 1963. Rather, it looked into the purposes of the issuance of that stock in 1945. Its conclusion that respondent should have capital treatment rested on two factual conclusions: (1) that the purpose of issuing the preferred stock was to meet the RFC's requirement that the shareholders provide greater working capital (App. A, *infra*, p. 12); and (2) that Tennessee Foundry (*id.*, p. 17) "had always intended to redeem Taxpayer's preferred stock when the [RFC] loan was paid off."

In thus looking (*ibid.*) "to the point in time when Taxpayer contributed the $25,000," the Court below is in direct conflict with the Fourth Circuit's decision in *Ballenger* v. *United States*, *supra*, and the Tenth Circuit in *Commissioner* v. *Berenbaum*, *supra*. Although *Ballenger* seems to reject the "flexible" net effect test and *Berenbaum* seems to accept it, both decisions hold that the business purpose for the issuance of preferred stock is not material in determining whether the later redemption is essentially equivalent to a dividend. Thus, in *Ballenger*, the Fourth Circuit stated (301 F. 2d at 199) that "we cannot understand how a valid reason for the issuance of preferred stock can, once its purposes have been served, be converted into a reason for its redemption"; and the Tenth Circuit has said much the same.

The facts of *Berenbaum* are strikingly similar to this case. There the preferred stock had been issued to increase the corporate capital as a condition to an FHA mortgage transaction. In *Ballenger,* the preferred stock was allegedly issued subject to the directions of a probate court, to protect the interest of the widow and child of a deceased former partner in the business, a purpose that for present purposes is indistinguishable from that relied on below.

4. The "strict" net effect test applied by the Second Circuit is in harmony with the Congressional intent with respect to the application of Section 302(b)(1). The decisions below and in the other courts of appeals which apply one of the variations of the "flexible" net effect test are wrong, in our view. Although cases decided under the Internal Revenue Code of 1939 may provide some support for the "flexible" test, use of the flexible test ignores the fact that Congress, in adopting the 1954 Code, "substantially recast the law in this field" (*Ballenger* v. *United States, supra,* 301 F. 2d at 194 (C.A. 4)) by laying down precise guidelines, or "safe harbors," for taxpayers seeking capital gain treatment. As the Second Circuit indicated in *Levin* v. *Commissioner,* 385 F. 2d 521, the 1954 legislative history of that section shows that Congress had an exceedingly narrow purpose in incorporating certain language of the 1939 Code into Section 302(b)(1).

As drafted by the House, the 1954 Code would have dropped the 1939 language and included only the present Sections 302(b)(2), (3), and (4). The Senate added Section 302(b)(1), but apparently to allow only

for such occurrences as the "redemption of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place." S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 44–45. As the leading commentators in the field observed, "It is not easy to give § 302 (b)(1) an expansive construction in view of this indication that its major function was the narrow one of immunizing redemptions of minority holdings of preferred stock." Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed. 1966) 291.

Notwithstanding this history, the court below found a lack of dividend equivalence in the most obvious dividend equivalence situation, *i.e.*, one where the redemption of stock is from the actual or constructive owner of all of the corporation's stock, both common and preferred. Section 318(a) of the Code, which is incorporated by reference into Section 302 (see Section 302(c)), requires that respondent "be considered as owning the stock owned * * * by * * * his spouse * * * and * * * his children * * *." In consequence, in determining whether the redemption of respondents' preferred stock comes within Section 302(b)(1), he is deemed the holder of all the outstanding stock of Tennessee Foundry. The redemption of the preferred stock of the sole shareholder is the opposite of what Congress had in mind in adopting Section 302(b)(1). The redemption therefore should be treated as a dividend, under Section 301, and not as a distribution in exchange for the stock, under Section 302.

5. As the number of appellate decisions of the last

several years indicates, the question in this case constantly recurs.[6] It has proved to be one of the most confused in tax litigation. Seldom has a tax problem produced such diversity of opinion among the courts of appeals.

This, moreover, is a question that particularly calls for a unitary resolution. It affects the planning of capital transactions in closely held corporations, and it is essential that tax practitioners and the Treasury have a settled rule whose application may safely be foreseen before a redemption is undertaken. This objective can be achieved and the confused state of the authorities can be put to rest only through review by this Court.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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JUNE 1969.

[6] We are aware of some 35 other cases pending in the courts which involve the application of Section 302(b)(1). The "business purpose" question has, to date, been raised in 15 of these cases. We have not been able to determine how many similar cases are pending at the administrative level.

APPENDIX A

No. 18487

In the United States Court of Appeals for the Sixth Circuit

MACLIN P. DAVIS AND EDITH U. DAVIS, PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

On Appeal from the United States District Court for the Middle District of Tennessee

Decided March 27, 1969

Before: O'SULLIVAN and CELEBREZZE, *Circuit Judges* and MCALLISTER, *Senior Circuit Judge.*

CELEBREZZE, Circuit Judge. The Government appeals a judgment of the United States District Court for the Middle District of Tennessee granting Taxpayer's [1] claim for refund of federal income taxes. The cause was heard on motions for summary judgment filed by both parties. On denial of its motion for rehearing the Government perfected this appeal. The

[1] Appellees filed a joint return. The designation "Taxpayer" throughout this opinion, however, shall refer to Maclin P. Davis.

question before us is whether a corporate distribution to Taxpayer, in redemption of all his preferred stock in the Corporation, was essentially equivalent to a dividend under Section 302(b)(1) of the Internal Revenue Code of 1954.[2]

In 1945, Taxpayer and one Bradley organized the Tennessee Foundry & Machinery Company (hereinafter Corporation) to manufacture steel castings. In exchange for equipment transferred to the Corporation, Bradley and Taxpayer each received fifty percent of its common stock. Prior to incorporation, Taxpayer had begun negotiations with the Reconstruction Finance Corporation (hereinafter RFC) for the purpose of obtaining a $95,000 loan to the Corporation. RFC agreed to make the loan on the condition that the incorporators provide the Corporation with additional working capital in the amount of $25,000. Bradley insisted on retaining his fifty percent of the voting power but was unwilling to invest any additional capital. In order to meet the demand of RFC, Taxpayer contributed the $25,000 in exchange for one hundred shares of six percent non-voting preferred stock with a par value of $25 per share. Taxpayer contended and the District Court found that the sole purpose of the transaction was to enable the Corporation to obtain the RFC loan and that the preferred

[2] "Sec. 302. Distributions in Redemptions of Stock.

"(a) General Rule.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

"(b) Redemptions Treated as Exchanges.—

"(1) Redemptions not equivalent to dividends.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend."

stock was to be redeemed when the loan was repaid. Thus, on the date of incorporation the capital structure of the Corporation was as follows:

	Common—%	Preferred—%
Bradley	500–50	
Taxpayer	250–25	1,000—100%
Taxpayer's Wife	250–25	

In 1952, Taxpayer purchased Bradley's common stock and in 1959 he transferred 250 shares to his son and 250 shares to his daughter. The original loan agreement provided that so long as part of the RFC loan was outstanding, no dividends could be paid without obtaining the written consent of RFC. Such permission was granted in 1960 and semiannual dividends were paid beginning on October 5th of that year.

On June 1, 1963 the loan was paid off and on September 23, 1963 the Corporation voted to redeem Taxpayer's preferred stock. On October 1, 1963 this stock was redeemed for $25,000, the amount Taxpayer paid for it. On this date the capital structure of the Corporation, reflecting the prior purchase of Bradley's shares by Taxpayer, was as follows:

	Common—%	Preferred—%
Taxpayer	250–25	1,000
Wife	250–25	
Son	250–25	
Daughter	250–25	

The Commissioner contended that the $25,000 was "essentially equivalent to a dividend" within the meaning of Section 302(b)(1) of the Code, hence tax-

able as ordinary income under Section 301 of the Code.[3] The District Court held to the contrary and granted Taxpayer's claim for refund. We affirm the judgment of the District Court.

Section 302 of the Code provides capital gains treatment to corporate distributions made in redemption of stock. The transaction is treated as a sale or exchange of a capital asset and gain is realized to the extent that the distribution exceeds a taxpayer's cost basis for the stock. Here, Taxpayer received back his cost basis for the stock so he had no gain. On the other hand, corporate distributions amounting to dividends are includable in their entirety in gross income and taxed at ordinary rates. Where the question is whether a particular corporate distribution is a redemption or dividend Section 302 provides several tests for determining the answer.[4] Since the Corporation was not liquidating its business and the stock redeemed was preferred stock with no voting rights, our inquiry is limited to Section 302(b)(1) which simply states the principle that a corporate distribution in exchange for stock is not a redemption if it is essentially equivalent to a dividend.[5]

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[3] Section 301(c) of the Code provides that gross income includes dividends. Section 316 of the Code defines a "dividend" generally as a distribution of property made by a corporation to its shareholders out of earnings and profits.

[4] Similar rules are contained throughout Code Sections 301-318 (distributions by corporations other than liquidating distributions) and Code Sections 331-346 (liquidating distributions.)

[5] By contrast, Subsections (2), (3), and (4) of Section 302 (b) contain objective tests for determining whether the distribution was a redemption. Subsection (2) provides that substantially disproportionate distributions with respect to the shareholder are to be treated as redemptions under Section 302(a).

We therefore look to the facts as found by the District Court to determine whether the distribution in issue was equivalent to a dividend. See *Ballenger* v. *United States,* 301 F. 2d 192 (4th Cir. 1962). The standard contained in Section 302(b)(1) calls for a factual resolution of the question and has been so used by the courts and the Commissioner. *Rheinstrom* v. *Commissioner,* 125 F. 2d 790 (6th Cir. 1942), cert. denied 317 U.S. 654; *Cobb* v. *Calan Court Co.,* 274 F. 2d 532 (5th Cir. 1960); *Colvin* v. *United States,* 175 F. Supp. 877 (S.D. Cal. 1959); Treasury Regulation 1.302-2(b). Our function on review is to determine whether the District Court applied the correct criteria to those facts. *Ballenger,* supra; but see *Pacific Vegetable Oil Co.* v. *Commissioner,* 251 F. 2d 682 (9th Cir. 1957) (dividend equivalency is mixed question of fact and law).

The purpose of the various tests in Section 302(b) of the Code is to prevent tax avoidance, more specifically, to prevent corporations from bailing out earnings to shareholders at favorable capital gains rates. To bring some objectivity to Section 302(b)(1), the Courts have established some guidelines which when applied to the facts of each case are calculated to determine whether a particular corporate distribution is in fact a dividend. Under the "strict net effect" test, if the taxpayer ends up in the same position after the distribution as he would have occupied

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By a limitation contained in that subsection, however, the shareholder must after the distribution end up with less than 50% of the total combined voting power in the corporation. Subsection (3) provides that a shareholder's stock is considered to be redeemed under Section 302(a) when he terminates his interest in the corporation. Subsection (4) deals with railroad corporations. This leaves for our consideration Subsection (1) of Section 302(b).

had a dividend been declared, the net effect of the transaction is held to be the payment of a dividend. See, *e.g., Commissioner* v. *Estate of Bedford,* 325 U.S. 283 (1945); *Levin* v. *Commissioner,* 385 F. 2d 521 (2d Cir. 1967). Applying the strict net effect test in the way that the Government urges, in 1963, Taxpayer—because of the attribution rules of Section 318[6] of the Code—would be considered as owning all of the common stock of the Corporation so the distribution to him in payment for his preferred stock was made pro rata on his common stock. The Government contends that a pro rata distribution by a corporation effecting no basic change in shareholder relationships is the hallmark of a dividend, therefore the payment to Taxpayer was "essentially equivalent to a dividend" and taxable as such. *Himmel* v. *Commissioner,* 388 F. 2d 815 (2d Cir. 1964); *Kerr* v. *Commissioner,* 326 F. 2d 225 (9th Cir. 1964) cert. denied 377 U.S. 963.

[6] Section 318(a)(1) makes Taxpayer the constructive "owner" of the common stock owned by his spouse and children. Since his spouse and children each owned 25% of the remaining 75% of the common stock of the Corporation, Taxpayer winds up with 100% of the common stock. Section 318(a) is made applicable to Section 302 generally by Subsection (c)(1) of Section 302. But whether the attribution rules apply specifically to Section 302(b)(1) has caused some controversy. See, *e.g.*, Comment, 47 Minn. Law Rev. 853, 867–70 (1963). The District Court held that they do apply to Section 302(b)(1). We agree to the extent that constructive ownership of stock may be used as a factor to determine whether the distribution in question is in reality a dividend. See Treas. Reg. 1.302–2(b). But, like the flexibility given to the strict net effect test, there may be situations where it would be unrealistic to apply the attribution rules in strict fashion, for instance in cases of family estrangement. *Levin* v. *Commissioner*, 385 F. 2d 521 (2d Cir. 1967); *Himmel* v. *Commissioner*, 338 F. 2d 815 (2d Cir. 1964).

The District Court, however, looked to the entire transaction and applied the "flexible net effect" test. Under this test, a business purpose for the redemption will temper the conclusiveness of a strict net effect result. See *Keefe* v. *Cote,* 213 F. 2d 651 (1st Cir. 1954). The Court looked to the point in time when Taxpayer contributed the $25,000 and found that the Corporation had always intended to redeem Taxpayer's preferred stock when the loan was paid off. We are aware that use of "busines purpose" to mollify the rigors of the strict net effect test has been criticized, see, *e.g., Levin* v. *Commissioner,* 385 F. 2d 521 (2d Cir. 1967), even by the First Circuit which purports to follow it. *Bradbury* v. *Commissioner,* 298 F. 2d 111 (1st Cir. 1962). Many courts, however, give it some weight. See *United States* v. *Fewell,* 255 F. 2d 496 (5th Cir. 1958); *Commissioner* v. *Berenbaum,* 369 F. 2d 337 (10th Cir. 1966); *Phelps* v. *Commissioner,* 247 F. 2d 156 (9th Cir. 1957); *Colvin* v. *United States,* 175 F. Supp. 877 (S.D.Cal. 1959); *Estate of Golwynne,* 26 T.C. 1209 (1956). In any event, the "strict net effect" test and the "flexible net effect" test complement each other in this respect: to the extent that the facts show a business purpose for the redemption there is an absence of the proscribed tax avoidance purpose to bail out dividends at favorable tax rates. See *Ballenger* v. *United States,* 301 F. 2d 192, 198 (4th Cir. 1962).

The Government concedes that there would be no issue of dividend equivalency here had the Corporation redeemed Taxpayer's preferred stock while Bradley owned fifty percent of the Corporation's common stock. A redemption of any of Taxpayer's preferred stock at such time would not have been a pro rata distribution on the Corporation's common stock. Nevertheless, armed with the strict net effect

test the Government contends that Taxpayer's subsequent acquisition by way of attribution under Section 318(a) of the Code of one hundred percent control of the Corporation converted the distribution to him in payment for his preferred stock into a dividend paid pro rata on the common stock. To expand upon the Government's argument, Taxpayer was precluded from withdrawing his $25,000 investment intact because his decision to buy out Bradley's interest and acquire control of the Corporation converted what would have been a straight stock redemption into a tax-avoidance scheme to bail out corporate earnings. We do not believe Congress intended that Section 302 of the Code should work such a harsh result especially since the primary purpose of capital gains treatment is to encourage individuals to risk capital for investment purposes. Although closely-held corporations call for close scrutiny under the tax law, we will not, under the facts and circumstances of this case, allow mechanical attribution rules to transform a legitimate corporate transaction into a tax avoidance scheme.

A transaction involving Section 306 of the Code illustrates the converse situation. Under that Section, preferred stock or its equivalent is treated for income tax purposes as a cash dividend where the preferred stock was originally distributed as a stock dividend pro rata on the outstanding common stock. Section 306(c)(1)(A) Internal Revenue Code of 1954. Under Section 305 of the Code stock dividends are not taxable. When Section 306 preferred stock is sold or redeemed, the payment for it is taxable at ordinary income rates unless the shareholder has at the same time terminated his interest in the corporation.[7] Before the enactment of Section

[7] Section 306 adopts the termination criterion of Section 302(b)(3) of the Code. See footnote 5, supra.

306, the use of the "preferred stock bail out" was a popular tax avoidance device and Section 306 was intended to eliminate it. Section 306 stock, however, does not lose its cash dividend character if the holder disposes of all or part of his common stock. Section 302(b)(3); cf. *Himmel* v. *Commissioner,* 338 F. 2d 815 (2d Cir. 1964). Likewise, Taxpayer's preferred stock did not become a cash dividend coverup even if the attribution rules are applied from the date he bought Bradley's common stock.

The facts of this case demand that substance win over form and that the entire transaction control the tax effect of the stock redemption in issue. As the District Court stated:

> "The subsequent acquisition of Bradley's stock holdings by taxpayer, making the redemption distribution essentially pro rata because of the § 318(a) attribution rules, neither impairs the legitimacy of the purpose underlying the issuance of the preferred stock [to provide additional security required by RFC] nor alters the fact that the redemption was simply the final [contemplated] step taken in completion of this purpose."

We conclude that the District Court was, under the facts and circumstances in this case, correct in holding that the redemption by the Corporation of Taxpayer's preferred stock was a distribution made in exchange for his stock and not a distribution that was "essentially equivalent" to a dividend.

Affirmed.

APPENDIX B

In the United States Court of Appeals for the Sixth Circuit

No. 18,487

MACLIN P. DAVIS AND EDITH U. DAVIS,
PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Before: O'SULLIVAN and CELEBREZZE, *Circuit Judges,* and MCALLISTER, *Senior Circuit Judge.*

JUDGMENT

Appeal from the United States District Court for the Middle District of Tennessee

This cause came on to be heard on the record from the United States District Court for the Middle District of Tennessee and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby affirmed.

It is further ordered that Plaintiff-Appellee recover from Defendant-Appellant the costs on appeal, as itemized below, and that execution therefor issue out of said District Court.

Entered by order of the Court.

CARL W. REUSS, *Clerk.*

Filed March 27, 1969.

APPENDIX C

Statute and Regulation Involved

Internal Revenue Code of 1954:

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) *In General.*—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * *

[26 U.S.C. 301.]

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) *General Rule.*—If a corporation redeems its stock (within the meaning of section 317 (b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated as Exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) *Substantially disproportionate redemption of Stock.*—

* * * * *

(3) *Termination of shareholder's interest.*—

(4) *Stock issued by railroad corporations in certain reorganizations.*—* * *

(5) *Application of paragraphs.*—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of pargraph (2), (3), or (4) shall not be taken into account. * * *

(c) *Constructive Ownership of Stock.*—

(1) *In general.*—Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section.

* * * * *

(d) *Redemptions Treated as Distributions of Property.*—Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

* * * * *

[26 U.S.C. 302.]

SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. * * *

* * * * *

[26 U.S.C. 316.]

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK.

(a) *General Rule.*—For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

(1) *Members of family.*—

(A) *In General.*—An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) his spouse * * *, and

(ii) his children, * * *.

* * * * *

[26 U.S.C. 318.]

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.302–2 *Redemptions not taxable as dividends.*

(a) The fact that a redemption fails to meet the requirements of paragraph (2), (3) or (4) of section 302(b) shall not be taken into account in determining whether the redemption is not essentially equivalent to a dividend under section 302(b)(1). See, however, paragraph (b) of this section. For example, if a shareholder owns only non-voting stock of a corporation which is not section 306 stock and which is limited and preferred as to dividends and in

liquidation, and one-half of such stock is redeemed, the distribution will ordinarily meet the requirements of paragraph (1) of section 302(b) but will not meet the requirements of paragraph (2), (3) or (4) of such section. The determination of whether or not a distribution is within the phrase "essentially equivalent to a dividend" (that is, having the same effect as a distribution without any redemption of stock) shall be made without regard to the earnings and profits of the corporation at the time of the distribution. For example, if A owns all the stock of a corporation and the corporation redeems part of his stock at a time when it has no earnings and profits, the distribution shall be treated as a distribution under section 301 pursuant to section 302(d).

(b) The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a). All distribution in pro rata redemptions of a part of the stock of a corporation generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding. However, for distributions in partial liquidation, see section 346. The redemption of all of one class of stock (except section 306 stock) either at one time or in a series of redemptions generally will be considered as a distribution under section 301 if all classes of stock outstanding at the time of the redemption are held

in the same proportion. Distribution in redemption of stock may be treated as distributions under section 301 regardless of the provisions of the stock certificate and regardless of whether all stock being redeemed was acquired by the stockholders from whom the stock was redeemed by purchase or otherwise. In every case in which a shareholder transfers stock to the corporation which issued such stock in exchange for property, the facts and circumstances shall be reported on his return except as provided in paragraph (d) of § 1.331–1. See sections 346(a) and 6043 for requirements relating to returns by corporations.

* * * * *

[26 C.F.R. 1.302–2.]

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JOHN F. DAVIS, CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1962

No. 282

UNITED STATES OF AMERICA,
Petitioner,

vs.

MACLIN P. DAVIS and EDITH U. DAVIS,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

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OPINION BELOW

The opinion of the Court of Appeals is reported at 408 F. 2d 1139 (1969).

STATEMENT

The Statement of the petitioner omits the significant facts (1) that the Tennessee Foundry & Machine Company had always intended to redeem the preferred stock when the RFC loan was paid off, and (2) that the redemption was simply the final step taken in completion of the original purpose to provide temporary working capital while the RFC loan was in effect, but no longer.[1]

REASONS THIS CAUSE SHOULD NOT BE REVIEWED

1. The decision below is not in conflict with a decision of another Court of Appeals on the same matter. The petition states that the Fourth Circuit's decision in *Ballenger* v. *United States*, 301 F. 2d 192, and the Tenth Circuit's decision in *Commissioner* v. *Berenbaum*, 369 F. 2d 337, "hold that the business purpose for the issuance of preferred stock is not material in determining whether the later redemption is essentially equivalent to a dividend." In *Ballenger*, however, the Court expressly held that there was "no legitimate business purpose" for the redemption (301 F. 2d 199); and in *Berenbaum* the Court emphasized the failure of the taxpayer to "come forward with additional evidence on the question" [of business purpose] after the basic facts had been stipulated and the issue had been placed in controversy by the pleadings. (369 F. 2d 341). In each of these cases, moreover, the distribution was substantially pro rata without applying the attribution rules.

---

1. The District Court and the Court of Appeals both relied strongly on these facts. 274 F. Supp. 466, 471; 408 F. 2d 1139, 1143-4.

In *Ballenger* the taxpayer husband owned all the common stock except one share in the name of his wife, which the Court said was "too small to upset the pro rata characterization of the distribution." (301 F. 2d 199). With respect to the taxpayer in *Berenbaum*, "there was no reduction in his control, and only an insignificant reduction in ownership represented by the redeemed shares." (369 F. 2d 341). There is no decided case in which a redemption has been held to be essentially equivalent to a dividend, solely because of application of the attribution rules, where a genuine business purpose existed, as in the instant case. Cf. *Perry S. Lewis*, 47 T. C. 129.

2. In this case, as in *Keefe* v. *Cote*, 213 F. 2d 651 (1 Cir.), there was a two-pronged transaction. The stockholder there obtained his stock as consideration for assuming a corporate indebtedness. When the corporation was in better financial shape, it redeemed the stock, restoring the status quo. In neither that case nor the instant case can the purpose of the redemption fairly be insulated from the purpose of the issuance. Here, moreover, there was a clearly identifiable date as of which the preferred stock was to be redeemed—the date of payment in full of the RFC debt. In this respect the preferred stock was like a subordinated debt. The Tax Court has consistently followed *Keefe* v. *Cote*, where there were similar two-pronged transactions, e.g., *Estate of Henry A. Golwynne*, 26 T. C. 1209, and *Joe L. Smith, Jr.*, 49 T. C. 476. The Fourth Circuit's inability, in *Ballenger*, to "understand how a valid reason for the issuance of preferred stock can, once its purposes have been served, be converted into a reason for its redemption," comes from the manner in which the proposition is phrased. There is no "converting" of one reason into another. The two "reasons" are opposite sides of the same coin.

3. The deficiency was determined in the instant case only because the taxpayer, Mr. Davis, bought Mr. Bradley's common stock and gave it to his children in 1952, during the interval between the issuance of the preferred stock in 1946 and its redemption in 1963. The Internal Revenue Service, on the theory that the attribution rules thereby became applicable, determined that he was the sole stockholder and that the redemption of his preferred stock was accordingly pro rata. The District Court and the Court of Appeals both held that this acquisition of the Bradley stock, followed by the gifts to his children, did not impair the legitimacy of the purpose underlying the issuance of the preferred stock or alter the fact that redemption was simply the final step taken in contemplation of the original purpose for which the preferred stock was issued. There is no decided case which takes a contrary position under similar facts. If business purpose is to be ignored, the attribution rules should not be applied, and the result will be the same. The Second Circuit, which held the attribution rules to be generally applicable under Section 302(b)(1), has recognized that there are situations in which the application of such rules would be "unwise" (*Levin* v. *Commissioner*, 385 F. 2d 521, 526); and if judge-made exceptions to applicability are allowable, the rules are simply not applicable as *rules*, but only as guides.

4. The legislative history of Section 302(b)(1) demonstrates that Congress in 1954 intended to perpetuate the existing tests under Section 115(g) of the 1939 Code as to whether a redemption is essentially equivalent to a dividend. A recent case pointing this out is *Arthur D. McDonald*, 52 T. C. ..... No. 8, filed April 16, 1969, where a redemption of preferred stock was held not to be essentially equivalent to a dividend because it resulted in a substantial change in the taxpayer's interest in the corporation. Such is admittedly the case here unless fiction is

substituted for fact by an unwarranted application of attribution rules which (if effect is to be given both to the basic Congressional intent and the literal statutory language) are made applicable only to paragraphs (2) and (3) of Section 302(b), where ownership of stock is specifically referred to.

5. The true basis for the requested review of this case seems to be the hope of obtaining from this Court a "unitary resolution" (p. 10) of "confusion in this area of tax law." (p. 4). This aim rests on the false assumption that a decision by this Court of this case could properly have a prospective effect on the decision of other cases involving the same statutory provision but essentially different facts. There is no suggestion in the petition that there is any pending case involving similar facts, although it is stated that there are some thirty-five cases pending in the courts which involve the application of Section 302(b)(1), and that in fifteen of these cases, the "business purpose" question has been raised (footnote 6). Perhaps an opinion of this Court in this case would include expressions "beyond the point involved" (*Humphrey's Executor* v. *United States*, 295 U. S. 602, 626), but such expressions do not come within the rule of *stare decisis* and would not have the quasi-legislative effect envisioned by the authors of the petition. It is the function of Congress, and not of this Court, to clarify the confusion referred to in the petition.

6. Where the decision has been for the government (or the Commissioner of Internal Revenue) in a tax case, but no clear-cut conflict between circuits in cases involving similar facts, the Solicitor General has consistently and successfully opposed the granting of certiorari, no matter how confusing the area or how clearly erroneous the decision below. A different rule for review should not be followed where the taxpayer happened to be successful below.

Moreover, in this case the decision below was clearly correct.

7. The opinion of the District Court was not annexed to the petition as required by paragraph 1 (i) of Rule 23.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 282

UNITED STATES OF AMERICA, PETITIONER

v.

MACLIN P. DAVIS AND EDITH U. DAVIS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (R. 28–36) [1] is reported at 274 F. Supp. 466. The opinion of the court of appeals (R. 39–46) is reported at 408 F. 2d 1139.

JURISDICTION

The judgment of the court of appeals (R. 47) was entered on March 27, 1969. The petition for a writ of certiorari was filed on June 25, 1969, and certiorari was granted on October 13, 1969. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

[1] "R." references are to the separately bound record appendix.

QUESTION PRESENTED

Whether the redemption by a corporation of its preferred stock, all of which was held by respondent, who was also the actual or constructive owner of all of the corporation's common stock, resulted in a corporate distribution to him which was essentially equivalent to a dividend within the meaning of Section 302 (b)(1) of the Internal Revenue Code, even though there was a business purpose for the issuance of the preferred stock.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 301, 302, 316 and 318 of the Internal Revenue Code [2] and Section 1.302–2 of the Treasury Regulations promulgated thereunder are set forth in the Appendix, *infra*, pp. 39–46.

STATEMENT

Respondent [3] and E. B. Bradley organized the Tennessee Foundry and Machine Company ("Tennessee Foundry") in April, 1945 for the purpose of manufacturing steel castings (R. 28). Bradley received 500 shares of common stock and respondent and his wife each received 250 shares of common stock in exchange for the property transferred to Tennessee Foundry (R. 29).

Prior to incorporation, respondent had entered into negotiations for a $95,000 loan to Tennessee Foundry

[2] All references are to the Internal Revenue Code of 1954 unless otherwise stated.

[3] All references to "respondent" are to Maclin P. Davis. Edith U. Davis is a party to this action only because a joint income tax return was filed.

which was essential to its ability to launch the proposed business. The prospective lenders, the Reconstruction Finance Corporation ("RFC") and a bank, had agreed to make the loan only if respondent and Bradley provided Tennessee Foundry with an additional $25,000 of working capital, either by making a loan evidenced by a subordinated deferred note or by purchasing additional stock (R. 28–29).

Bradley was unable or unwilling to invest additional capital but insisted on retaining 50 percent of the voting power. As a result, the only methods of raising the additional capital considered by respondent were the purchase by him of preferred stock or the taking of subordinated debentures in exchange for a loan. Respondent selected the former, giving as his reason that preferred stock was better than a loan from a balance sheet standpoint (R. 9, 29).

Upon approval of the loan application by RFC, respondent purchased 1,000 shares of six percent preferred stock at a par value of $25 per share. Thus, on the date of incorporation or shortly thereafter, the outstanding shares were held as follows (R. 29):

Shareholder	*Common*	*Preferred*
E. B. Bradley	500	
Maclin P. Davis	250	1,000
Edith U. Davis	250	

In 1952, respondent purchased Bradley's 500 shares of common stock and, in 1959, transferred 250 of these shares to his son, M. P. Davis, Jr., and 250 shares to his daughter, Edith D. Whiteman. Consequently, at the

time of the redemption in issue, the outstanding shares were held as follows (R. 29–30):

Shareholder	*Common*	*Preferred*
Maclin P. Davis	250	1,000
Edith U. Davis	250	
Maclin P. Davis, Jr	250	
Edith D. Whiteman	250	

On September 23, 1962, after final payment on the RFC loan had been made, Tennessee Foundry's board of directors resolved to redeem the preferred stock by accepting respondent's offer to transfer these shares in exchange for $25,000. On October 1, 1963, respondent surrendered the certificate representing the stock and was paid $25,000 (R. 30).

For income tax purposes, respondent treated the transaction as a sale of preferred stock resulting in no gain to him because his basis for the stock was $25,000. The Commissioner of Internal Revenue determined that the distribution of the $25,000 was essentially equivalent to a dividend and was taxable as ordinary income. This determination was premised on the Commissioner's finding that, by reason of statutory rules of attribution, respondent must be deemed the owner of all of Tennessee Foundry's stock immediately before and after the redemption.

Respondent paid the resulting deficiency and later instituted this suit for refund (R. 4–5). The district court decided the issue for respondent (R. 28–36) and the Sixth Circuit affirmed (R. 39–46). Both courts held that, although respondent was the actual or constructive owner (by reason of statutory rules of attribution) of all of Tennessee Foundry's outstanding stock immediately before and after the redemption,

the redemption nevertheless was not essentially equivalent to a dividend. Each court relied on the showing of business purpose for the original issuance of the the preferred stock. The Sixth Circuit particularly stressed the absence of a tax avoidance purpose to "bail out" dividends at favorable tax rates (R. 43–45).

This Court granted the government's petition for certiorari on October 13, 1969 (R. 48).

ARGUMENT

INTRODUCTION AND SUMMARY

The question in this case is whether the $25,000 received by respondent upon the redemption of his preferred stock in 1963 is to be treated as a dividend, taxable as ordinary income, or as "payment in exchange for the stock," subject to capital gain taxation.[4] The statutory scheme for the taxation of stock redemptions is contained in Section 302. It is somewhat complicated in terms, but may be summarized as follows. Section 302(a) provides that the redemption shall be treated as a distribution in "payment in exchange for the stock" if any of the four paragraphs of Section 302(b) applies. These four paragraphs apply when the redemption is—(1) "not essentially equivalent to a dividend"; (2) a substantially disproportionate redemption of voting stock; (3) in complete termination of the shareholder's interest; or (4) in connection with certain railroad reorganizations. The parties are agreed that the answer to the question

[4] The latter treatment would, in this case, result in no tax because respondent's basis in the preferred stock was $25,000 and, therefore, there would be no gain on the exchange.

presented turns solely upon the application of paragraph (b)(1),[5] and that paragraphs (b) (2), (3) and (4) are not applicable to the facts of this case.

If none of these four paragraphs applies, Section 302(d) provides that the redemption is to be taxed in accordance with Section 301 which prescribes the general rule for taxing distributions to shareholders. Under Section 301(c)(1) and by its reference to Section 316, distributions of corporate property to shareholders are treated as dividends, taxable as ordinary income to the extent of the corporation's accumulated earnings and profits.

Since it is conceded that Tennessee Foundry had at least $25,000 of accumulated earnings and profits at the time of the redemption in issue, the distribution to respondent will be taxed as a dividend, in accordance with Sections 302(d), 301(c)(1) and 316, if it is "essentially equivalent to a dividend." On the other hand, if the redemption is "not essentially equivalent to a dividend" within the meaning of Section 302(b)(1), the distribution will be treated as being in exchange for the stock redeemed pursuant to Section 302(a). The ultimate issue, therefore, is the meaning of the statutory phrase "essentially equivalent to a dividend."

That phrase must be interpreted here in conjunction with the statutory rules of stock attribution prescribed in Section 318(a)(1)(A). This section, which is in-

[5] Section 302(b)(1), in its entirety, provides:

(b) *Redemptions Treated as Exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

corporated by reference into Section 302 (see Section 302(c)), provides that a taxpayer "shall be considered as owning the stock owned * * * by * * * his spouse * * * and * * * his children * * *." In consequence, in determining whether the redemption of respondent's preferred stock was essentially equivalant to a dividend, he must be deemed the owner of all of the outstanding Tennessee Foundry stock immediately before and after the redemption.[6]

Our principal contention in this brief is that a redemption is "not essentially equivalent to a dividend" only if the result of the redemption is to effect a meaningful reduction in the proportionate interest in the corporation of the shareholder whose stock is redeemed. Where, on the other hand, a shareholder receives cash, separated from the corporation, and in return relinquishes stock certificates without in any way reducing his proportionate interest in the enterprise, we view the redemption as being "essentially equivalent to a dividend" because, like a dividend, it gives him cash separated from the corporation, but the redemption has no effect on the proportionate stock interest of the recipient shareholder.[7]

Almost all of the courts of appeals have now con-

[6] Respondent argued below that the statutory attribution rules were inapplicable in this case. Both courts below rejected this contention. We deal with respondent's argument at pp. 32–37, *infra*.

[7] We do not mean to suggest that dividend equivalence results *only* when there is no reduction whatever in the shareholder's proportionate interest. Such equivalence may exist when there is a reduction that is not of sufficient magnitude to be substantially disproportionate under Section 302(b)(2). See *Commissioner* v. *Berenbaum*, 369 F. 2d 337, 341 (C.A. 10).

sidered the issue which this case presents.[8] All of them have recognized that "[i]f there is no significant reduction in the taxpayer's control or ownership the distribution in redemption of stock savors of a dividend," *Commissioner* v. *Berenbaum*, 369 F. 2d at 341, and that "[d]ividends are distributions of earnings and profits to the stockholders which do not change their proportionate interests in the corporation," *Bradbury* v. *Commissioner*, 298 F. 2d at 115. Thus, the courts have held distributions to be essentially equivalent to dividends when the shareholder whose stock was redeemed owned, both before and after the redemption, all of the outstanding stock of the corporation. *McGinty* v. *Commissioner, supra; Hasbrook* v. *United States, supra; Ballenger* v. *United States, supra; Kerr* v. *Commissioner, supra; Tabery* v. *Commissioner, supra.* Such a situation is a classic example of a redemption which does not result in a reduction in the shareholder's proportionate interest in the corporation.

The test enunciated in the cases discussed above (sometimes referred to as the "net effect" test[9]) has been universally accepted by the courts. However, as

[8] See *Keefe* v. *Cote*, 213 Fd 24 651 (C.A. 1); *Bradbury* v. *Commissioner*, 298 F. 2d 111 (C.A. 1); *McGinty* v. *Commissioner*, 325 F. 2d 820 (C.A. 2); *Hasbrook* v. *United States*, 343 F. 2d 811 (C.A. 2); *Levin* v. *Commissioner*, 385 F. 2d 521 (C.A. 2); *Kessner* v. *Commissioner*, 248 F. 2d 943 (C.A. 3); *Ballenger* v. *United States*, 301 F. 2d 192 (C.A. 4); *Commissioner* v. *Estate of Antrim*, 395 F. 2d 430 (C.A. 4); *United States* v. *Fewell*, 255 F. 2d 496 (C.A. 5); *Kerr* v. *Commissioner*, 326 F. 2d 225 (C.A. 9); *Tabery* v. *Commissioner*, 354 F. 2d 422 (C.A. 9); *Commissioner* v. *Berenbaum, supra.*

[9] *Flanagan* v. *Helvering*, 116 F. 2d 937 (C.A.D.C.)

noted in our petition, the circuits are divided over whether to apply the "strict net effect" test, as the Commissioner urges, or the "flexible net effect" test, which the Sixth Circuit held to be controlling.[10] The difference is that while both tests recognize the significance of whether the redemption results in a surrender of a portion of the shareholder's corporate ownership, the flexible net effect test considers the additional issue of whether there was a business purpose for the redemption. Under the strict net effect test, the presence or absence of a business purpose is irrelevant. Under the flexible net effect test, the redemption distribution need not be treated as a dividend if the redemption was motivated by a business purpose, even though no change in proportionate ownership results from the redemption.

Respondent acknowledged below that the redemption of his preferred stock would be subject to dividend treatment if the strict net effect test applies, or if the flexible net effect test applies but there was no business purpose for the redemption, provided, in either case, that respondent is deemed to own the shares of Tennessee Foundry stock actually owned by his wife and children. Accordingly, in Point I of this brief, we contend that the lower courts erred in considering business purpose in the application of the critical statutory phrase "not essentially equivalent to a dividend." We shall there argue that business

[10] Compare *Levin* v. *Commissioner*, *supra*. and *Kessner* v. *Commissioner*, *supra;* with *Keefe* v. *Cote*, *supra; United States* v. *Fewell*, *supra; Sullivan* v. *United States*, 363 F. 2d 724 (C.A. 8); *Kerr* v. *Commissioner*, *supra;* and *Sorem* v. *Commissioner*, 334 F. 2d 275 (C.A. 10).

purpose is irrelevant in determining dividend equivalence and that, properly construed, Section 302(b)(1) calls for application of the strict, rather than the flexible, net effect test. In Point II, below, we contend that even if business purpose is a relevant statutory consideration, there was no business purpose for the redemption of respondent's preferred stock. Finally, in Point III, we will show that the courts below correctly rejected respondent's argument that the statutory rules of attribution do not require attribution to respondent of the Tennessee Foundry stock owned by members of his immediate family.

I. A REDEMPTION IS ESSENTIALLY EQUIVALENT TO A DIVIDEND IF IT DOES NOT CHANGE THE SHAREHOLDER'S PROPORTIONATE INTEREST IN THE CORPORATION

The search for the meaning of the phrase "essentially equivalent to a dividend" involves the examination of the concept of "dividend" as it has evolved in decisions of this Court. For this purpose, it is helpful to observe that the decisions have disclosed two variables, either of which may or may not be present. These are (1) the separation (or not) of cash or other property from the corporation and (2) the existence (or not) of a change in the proportionate interest of the shareholder in the corporation. These two variables may be presented in four combinations.

1. Perhaps the classic case is the stock dividend of common stock on common stock, which was involved in *Towne* v. *Eisner,* 245 U.S. 418, and in *Eisner* v. *Macomber,* 252 U.S. 189, as well as in the earlier nontax case of *Gibbons* v. *Mahon,* 136 U.S. 549. In this situation, there is neither any separation of assets

from the corporation, nor any change in the proportionate interest of the shareholder. It was settled nearly fifty years ago in *Eisner* v. *Macomber, supra,* that such a stock distribution does not constitute income.

In dealing with this question (for purposes of trust income, not taxation) in *Gibbons* v. *Mahon, supra,* the Court referred to the fact that "the proportional interest of each shareholder remains the same," and added that "the new shares and the original shares together [represent] the same proportional interest that the original shares represented before the issue of new ones." 136 U.S. at 559–560. This language was quoted by the Court in *Towne* v. *Eisner, supra,* 245 U.S. at 426, and the quotation from *Towne* v. *Eisner,* including the quotation from *Gibbons* v. *Mahon,* was quoted by the Court in *Eisner* v. *Macomber, supra,* 252 U.S. at 202–203.

2. There may be *no* separation of cash or property from the corporation, but there *is* a change in the proportionate interests of the shareholders. This was the situation in *Koshland* v. *Helvering,* 298 U.S. 441, where the taxpayer owned preferred stock, and received dividends on these shares which were paid in common stock. Thus, there was no separation of assets from the corporation, but the Court held that the receipt of the common shares did constitute income, since there was a change in the proportionate interest of the shareholders. To the same effect is *Helvering* v. *Gowran,* 302 U.S. 238, where the distribution was in preferred stock on common shares, when both preferred and common shares were outstanding.

Next we turn to the cases where there is a separation of assets from the corporation:

3. This situation may be presented where there is a partial liquidation of the corporation. Thus, one of several shareholders may turn in his shares and receive cash. In this case, there is a separation of assets from the corporation, and there is a corresponding change in the proportionate interest of the shareholder in the corporation. He has, in effect, sold his shares to the corporation. He has given up something—not just a piece of paper—but a portion of his interest in the corporation, changing his relative interest with respect to other shareholders. For this he has received cash. Such a redemption, having the essence of a sale, with something of substance given by the shareholder, and something received from the company, is taxable as a capital gain, either under Section 302, or under Section 346 in proper circumstances.

As far as the shareholder is concerned, this is not different from a sale for cash to an outsider. In each case, the shareholder receives cash. In each case he gives up a portion of his interest in the corporation. It is appropriate that the tax law should recognize both as capital transactions.

4. Finally, we come to the situation where there is (1) a separation of cash or property from the corporation, and (2) no change in the shareholder's proportionate interest in the business. The simplest instance of this is, of course, the ordinary cash dividend. There is no doubt that such a payment, when the corporation has earnings and profits, is taxable to the recipient as ordinary income.

Is the result different when the payment of cash by the corporation is accompanied by a turning in of some of the shareholder's shares' but without any change in his proportionate interest in the company? That is the question in this case. Here, before the payment by the company, the taxpayer owned all of the shares of the company, both common and preferred, pursuant to the attribution rules prescribed by Congress in Section 318. For the purposes of this case, he is to be treated as owning all of the equity interest in the company.[11] After the transaction, the taxpayer had $25,000 in cash, received from the company, and he still is to be treated as owning the entire equity interest in the company. There has been a separation of assets from the company, and there has been no change in his proportionate interest. It is true that he has turned in his preferred shares, and has only common left. But this is a formality. He now has $25,000, and

[11] It will not do to say, "But the taxpayer did not really have all of the equity interest in the corporation. Some of it was owned by his wife, son and daughter." For Congress has expressly dealt with this question, and has said in Section 318 that the taxpayer "shall be considered as owning the stock owned, directly or indirectly, by * * * his spouse * * * and his children." In this case, $25,000 has come out of the corporation, and the corporation had earnings and profits to that extent. Congress clearly has power to prescribe how that $25,000 is to be treated for tax purposes, and Congress has determined that the question is to be resolved, in these circumstances, by the same tests as would be applied if the taxpayer did in fact own all of the shares in the corporation. There is nothing arbitrary about this. It is simply the resolution by Congress of the question how tax liability is to be determined in this situation.

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the same equity interest—represented by fewer pieces of paper than he had before.

In *Eisner* v. *Macomber, supra,* no income was found in the receipt of pieces of paper representing exactly the same interest which the taxpayer had before they were received. By the same token, here the cash which the taxpayer did receive should not be regarded as other than a distribution of earnings from the corporation merely because the shareholder now has fewer pieces of paper representing exactly the same interest (namely, the entire ownership) as he had before, apart from the $25,000 he has received. His economic position is exactly the same as that of the shareholder who has received a $25,000 dividend. He has the same amount of cash, and exactly the same proportionate ownership in the same underlying assets. The only difference is that he has fewer pieces of paper representing his ownership interest; and *Eisner* v. *Macomber* shows that the presence or absence of pieces of paper representing the same ownership interest is not significant for tax purposes.

In holding that the distribution to respondent was "not essentially equivalent to a dividend," the courts below failed to take account of the distinction between a dividend and a transaction, like a sale to outsiders, which changes the shareholder's proportionate interest in the corporation. The latter results in a reduction in the percentage of corporate ownership; the former does not. Congress' intention, however, in enacting Section 302(b)(1) was, we submit, to draw a distinction between redemptions that have the effect

of a dividend—that is, those which leave the shareholder's proportionate ownership interest undisturbed—and redemptions which more nearly resemble sales because they result in a reduction in the shareholder's proportionate ownership interest. This intention is manifested by the plain language of Section 302, its overall structure and unequivocal legislative history.

Section 302(a) provides that if any of the four paragraphs of Section 302(b) applies, the redemption shall be treated as a distribution in "payment in exchange for the stock." This means that only the gain or loss on the exchange (the difference between the amount of the distribution and the basis for the stock) will be taken into account for tax purposes. On the other hand, if the redemption is treated as a dividend, the entire amount of the distribution is subject to the provisions of Section 301.[12] Under the teaching of *Eisner* v. *Macomber, supra,* where, as in this case, a shareholder has the same proportionate ownership interest in a corporation before and after a redemption, his economic position is not changed, except that—as in the case of a dividend—he has received cash from the corporation. His surrender of shares is not "an economically meaningful gesture" but "a sterile exercise in formalism." *Bradbury* v. *Commissioner,* 298 F. 2d at 114. There is thus no reason for treating the

[12] Under our view of the redemption in this case, respondent's basis in the preferred stock would not be lost. It would be used to increase the basis for respondent's common stock in Tennessee Foundry by $25,000. See Section 1.302-2(c), Treasury Regulations on Income Tax (1954 Code), and the examples thereunder.

redemption as a distribution in "payment in exchange for the stock" under Section 302(a), since the economic consequences of the transaction, both to the corporation and the shareholder, would have been identical had the distribution been made without a surrender of stock certificates.

Like redemptions that are "not essentially equivalent to a dividend," redemptions described in Sections 302 (b)(2) and (b)(3) are to be treated as distributions in "payment in exchange for the stock."[13] Although the latter provisions are not involved in this case, they plainly apply only when a shareholder has changed his proportionate ownership interest in a corporation. Section 302(b)(3) deals with redemptions in which a shareholder's corporate interest in completely terminated, and Section 302(b)(2) applies where there has been a substantially disproportionate redemption of a shareholder's voting stock. Section 302(b)(1) is essentially the converse of Section 302 (b)(2), except that it may also apply to a redemption of non-voting stock, where there is a change in the proportionate interest of the shareholder. Section 302 (b)(2) says there is not a dividend when there is a substantial change of proportionate interest, while the essential effect of Section 302(b)(1) is that there *is* a dividend when there is *no* change in proportionate interest. The pertinent legislative history gives no hint that Congress intended, by enacting Section 302 (b)(1), to depart from the common principle under-

[13] Section 302(b)(4) is a special provision applicable only to redemptions of stock issued by railroad corporations in reorganizations under Section 77 of the Bankruptcy Act.

lying Sections 302(b) (2) and (3), that a redemption may be treated as an exchange only when a shareholder has changed his proportionate interest in the corporation. In the absence of any evidence of such Congressional intention, it is reasonable, considering the statutory framework of Section 302(b), to interpret Sections 302(b)(1)–(3) consistently as adhering to the principle to which we have referred.

There is no need, however, to draw a conclusive inference regarding the proper interpretation of Section 302(b)(1) from a lack of evidence indicating that this provision was based on a principle other than that underlying the companion provisions of Sections 302(b) (2) and (3); for Congress made its intentions clear when it enacted Section 302(b)(1).

As passed by the House, H.R. 8300, the bill which became the Internal Revenue Code of 1954, included no provision comparable to what is now Section 302 (b)(1). The House bill prescribed capital gains treatment for redemptions primarily in circumstances similar to those presently described in Sections 302(b) (2) and (3). See H. Rep. No. 1337, 83d Cong., 2d Sess., pp. 35–36. These provisions had no counterparts in the Internal Revenue Code of 1939. The House's purpose in substituting specific tests for the "essentially equivalent" to a dividend language which appeared in Section 115(g)(1) of the 1939 Code[14] was to eliminate

[14] Section 115(g)(1) read in its entirety as follows:

(g) Redemption of stock.

(1) In general.

If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part

"the considerable confusion which exists in this area" H. Rep. No. 1337, *supra,* at 35, and thereby to facilitate tax planning.

The Senate Finance Committee added Section 302 (b)(1), explaining its action as follows (S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 44–45):

> While the House bill set forth definite conditions under which stock may be redeemed at capital-gain rates, these rules appeared unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place. Accordingly, your committee follows existing law by reinserting the general language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend. * * *

That the Finance Committee intended Section 302 (b)(1) to have a narrow application (not covering the present case) is apparent from the foregoing explanation.[15] That the Committee did not intend to depart from the general principle that a redemption

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> essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

[15] As the leading commentators in the field have observed, "It is not easy to give § 302(b)(1) an expansive construction in view of this indication that its major function was the narrow one of immunizing redemptions of minority holdings of preferred stock." Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed. 1966), 291.

may be treated as an exchange only when a shareholder reduces his proportionate interest in a corporation also is apparent. In its technical explanation of H.R. 8300, the Committee had this to say about Section 302(b)(1) (S. Rep. No. 1622, *supra,* at 234):

> The test intended to be incorporated in the interpretation of paragraph (1) is in general that currently employed under section 115(g)(1) of the 1939 Code. *Your committee further intends that in applying this test for the future that the inquiry will be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation.* [Emphasis added.]

As we have previously shown (pp. 12, 14–15, *supra*), the characteristic of a sale, which distinguishes it from a dividend, is that the former results in a reduction of the shareholder's proportionate interest, while the latter does not. It thus would be directly contrary to Congress' plain intention to give Section 302(b)(1) the expansive interpretation urged by respondent. Indeed, to allow capital gains treatment where a shareholder owns all of the corporation's outstanding stock both before and after the redemption, so that the distribution to him necessarily is pro rata, would be squarely inconsistent with the Finance Committee's understanding that only those redemption distributions which "are not made pro rata" "may have capital-gain characteristics." S. Rep. No. 1622, *supra,* at 49.

The Finance Committee's admonition (*id.* at 234), that in determining dividend equivalence under Sec-

tion 302(b)(1), the inquiry is to be "* * * devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale * * *," undoubtedly was directed to the confusion that existed prior to 1954. There were numerous decisions under Section 115(g)(1) and its predecessor provisions [16] which held that the business purpose for a redemption, as well as its effect, was to be taken into account in determining dividend equivalence. We think these cases were wrongly decided. They ignored legislative history accompanying the Revenue Act of 1926 which shows that, in the area of dividend equivalence, Congress never intended to attribute any significance to business purpose.[17] In commenting on the dividend equivalence provision of the 1926 Act, the House Ways and Means Committee discussed *only* the effect of the redemption. Its report stated (H. Rep. No. 1, 69th Cong., 1st Sess., p. 5):

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[16] Section 115(g)(1) is set out in full at pp. 17–18, n. 14, *supra*. It originated as Section 201(d) of the Revenue Act of 1921, c. 136, 42 Stat. 227, and was carried forward in the Revenue Act of 1924, c. 234, 43 Stat. 253, as Section 201(f). These provisions of the 1921 and 1924 Acts were responsive to this Court's holding in *Eisner* v. *Macomber*, *supra*, that stock dividends that do not change a shareholder's proportionate interest in a corporation do not constitute taxable income, and applied only in cases involving redemptions by corporations that issued stock dividends. In Section 201(g) of the Revenue Act of 1926, c. 27, 44 Stat. 9, the coverage was expanded to include all redemptions that were essentially equivalent to a dividend, whether or not the redeeming corporation had issued stock dividends. Section 201(g) of the 1926 Act was carried forward in each successive revenue statute and finally appeared in substantially unchanged form as Section 115(g)(1) of the 1939 Code.

[17] As set out in note 16, *supra*, Section 115(g)(1) is the substantially unchanged successor of the dividend equivalence provision of the Revenue Act of 1926.

> It has been contended that under existing law a corporation, especially one which has only a few stockholders, might be able to make a distribution to its stockholders which would have the same effect as a taxable dividend. For example: Assume that two men hold practically all the stock in a corporation, for which each had paid $50,000 in cash, and the corporation had accumulated a surplus of $50,000 above its cash capital. It is claimed that under existing law the corporation could buy from the stockholders, for cash, one-half of the stock held by them and cancel it without making the stockholders subject to any tax. *Yet this action, in all essentials, would be the equivalent of a distribution through cash dividends of the earned surplus.* The amendment proposed to this subdivision is intended to make clear that such a transaction is taxable. [Emphasis added.]

The Senate Finance and House Conference Committee reports on the 1926 Act include statements almost identical to that of the Ways and Means Committee. S. Rep. No. 52, 69th Cong., 1st Sess., p. 15; H. Conf. Rep. No. 356, 69th Cong, 1st Sess, p. 30. These explanations leave no room for the attribution of any significance to the business purpose concept. See *Smith* v. *United States* 121 F. 2d 692 (C.A. 3).

In addition to disregarding the 1926 Act legislative history, the early dividend equivalence cases also relied heavily on language that appeared in Section 115(g)(1) of the 1939 Code and its predecessors, but which was not carried forward into the 1954 Code. See, *e.g., Commissioner* v. *Cordingley,* 78 F. 2d 118 (C.A. 1); *Commissioner* v. *Quackenbos,* 76 F. 2d 156

C.A. 2). Under the prior provisions, dividend treatment was required if the corporation redeemed its stock "at such time and in such manner" as to make the redemption essentially equivalent to a dividend. Seizing on the "at such time and in such manner" language, the courts read business purpose into the dividend equivalence test.[18]

Whatever may explain the confusion under prior law, there is no reason to perpetuate it under the 1954 Code. Congress has made its intentions clear in the legislative history of Section 302(b)(1), and it has deleted the language of the earlier law upon which the courts relied in departing from the strict net effect test.[19]

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[18] Also cited in *Cordingley* and *Quackenbos*, *supra*, are decisions interpreting the Revenue Acts of 1921 and 1924 to mean that dividend equivalence could be established only if the motive for the redemption was tax avoidance. As the history of the 1926 Act shows, see pp. 20–21, *supra*, even under those Acts it was not Congress' intention that what was, in effect, a dividend should be taxed other than as a dividend. In any event, Congress clearly provided beginning in 1926 that capital gains treatment was to be available only when a shareholder changed his proportionate interest by the redemption.

[19] Section 346(a)(2) of the Code provides that a distribution in redemption of part of the stock of a corporation will be treated as being in partial liquidation of the corporation (and hence taxed as capital gain) if, *inter alia*, it is "not essentially equivalent to a dividend." Such a partial liquidation may occur, for example, where there is a definite contraction in the corporate operations, such as (but not limited to) the termination of a portion of the corporation's business (see Section 346(b)). In such a situation it can be said that the shareholder surrendered a portion of his ownership interest in exchange for those assets distributed to him which formerly were used in conducting the corporation's activities, and though he owns,

The court below regarded business purpose as relevant on the ground that the presence of such a purpose tended to negate a tax avoidance motive for the redemption. Thus the court said (R. 42–43, 44):

> The purpose of the various tests in Section 302(b) of the Code is to prevent tax avoidance, more specifically, to prevent corporations from bailing out earnings to shareholders at favorable capital gains rates. * * * [T]o the extent that the facts show a business purpose for the redemption there is an absence of the proscribed tax avoidance purpose to bail out dividends at favorable tax rates. * * *

This approach assumes that it is proper to grant preferential treatment under Section 302(b)(1) to certain distributions which, in all other respects, are essentially equivalent to a dividend, but were not motivated by an improper (*i.e.*, tax avoidance) purpose. We do not believe this is a proper limitation on the statute. A shareholder who receives a distribution in redemption of shares, but without a termination of any portion of the business, and without any change in his proportionate interest, has changed "only the form, not the essence" of his capital investment. *Eisner* v. *Macomber, supra,* at 210. He is in no different position, no matter how pure his motives, than another shareholder who receives a distribution that is called a dividend. Simple equity demands that the two be taxed identically, and Section 302(b)(1) undertakes to insure that they will be.

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after the redemption, the same proportionate interest, it is an interest in a smaller and different business. For this reason the distribution is "not essentially equivalent to a dividend."

Our view of Section 302 does not mean that the statute was not intended to prevent tax avoidance. Section 302 does prevent tax avoidance as a factual matter by causing certain corporate distributions which are essentially equivalent to a dividend to be taxed as such even though they were not so denominated. But it is not aimed at tax avoidance as a motivational matter; nor is it intended to be limited to instances where such avoidance motivation is present. Rather, it is designed to prevent the fact of tax avoidance, whether or not the taxpayer is improperly motivated.

When Congress intends tax consequences to turn on the taxpayer's motivation, rather than on objective facts, it has made its intention plain. For example, Sections 269 and 1551 expressly state that the deductions or other benefits otherwise provided under the Code shall not be allowed if the taxpayer's purpose in acquiring stock or other property is tax avoidance, and Section 531 imposes the accumulated earnings tax on corporations that are availed of for the purpose of avoiding the individual income tax on their shareholders. Similarly, fraud penalties are imposed (*e.g.*, under Section 6653) when the taxpayer's purpose in failing to file a return or filing a false return is to avoid the payment of tax.

Most nearly in point is Section 306 which, as the court of appeals explained (R. 45), was designed to eliminate the use of the so-called preferred stock "bail out." See *Chamberlin* v. *Commissioner,* 207 F. 2d 462 (C.A. 6), certiorari denied, 347 U.S. 918. Unlike Section 302, Section 306 includes a specific provision—Section 306(b)(4)—which provides that the general

rule of Section 306, converting what would otherwise be capital gain on the redemption or other disposition of certain stock into ordinary income, is not to apply when the bail out "was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax." [20] Had Congress intended to include under Section 302(b) a comparable provision permitting capital gains treatment for redemptions that are not motivated by tax avoidance, it could readily have done so. The fact that it did not confirms that "[i]t is the effect of the redemption, rather than the purpose which actuated it, which controls the determination of dividend equivalence." *Kessner* v. *Commissioner*, 248 F. 2d 943, 944 (C.A. 3).

II. ASSUMING ARGUENDO THAT A BUSINESS PURPOSE COULD PREVENT A REDEMPTION FROM BEING ESSENTIALLY EQUIVALENT TO A DIVIDEND, THERE WAS NO BUSINESS PURPOSE FOR THE REDEMPTION OF RESPONDENT'S STOCK

Even if the Court should reject the contentions set forth in the preceding section of this brief, we submit that the decision below should nevertheless be reversed. If business purpose is relevant under Section 302(b), respondent has not established such a purpose in this case.

Respondent did establish a business purpose for the original issuance of the preferred stock—to increase the capital of the corporation and thereby secure the RFC loan. He did not, however, show a business pur-

[20] Respondent's preferred stock would in no event be subject to the rules of Section 306 because respondent purchased the stock. See Section 306(c).

pose for the redemption of his preferred stock after the loan was repaid.

The pertinent inquiry under Section 302(b)(1) is whether the redemption is essentially equivalent to a dividend, not whether there was a valid business purpose for issuance of the stock that ultimately was redeemed. Therefore, the only facts to be taken into account under the statute are those surrounding the stock redemption. This is the essence of the Fourth Circuit's decision in *Ballenger* v. *United States,* 301 F. 2d 192, and that of the Tenth Circuit in *Commissioner* v. *Berenbaum,* 369 F. 2d 337.

The facts in *Berenbaum* are strikingly similar to those of this case. There the preferred stock had been issued to increase the corporate capital as a condition to an FHA mortgage transaction. In *Ballenger,* the preferred stock was allegedly issued, subject to the direction of a probate court, to protect the interest of the widow and child of a deceased former partner in the business, a purpose which for present purposes is indistinguishable from that relied on below. In rejecting the taxpayer's claim that the redemption of the preferred stock was "not essentially equivalent to a dividend," the Fourth Circuit stated (301 F. 2d at 199) that "we cannot understand how a valid reason for the issuance of preferred stock can, once its purposes have been served, be converted into a reason for its redemption." [21]

[21] The Fifth Circuit has taken a contrary position, *Cobb* v. *Callan Court Co.*, 274 F. 2d 532, as the First Circuit seems to have done in *Keefe* v. *Cote*, 213 F. 2d 651. However, in *Bradbury* v. *Commissioner*, 298 F. 2d 111, the First Circuit expressed doubt regarding its earlier decision. Furthermore, in

Respondent insists that he is entitled to look "to the point in time when [he] contributed the $25,000" (R. 44) because it was understood at that time that he would be permitted to withdraw the $25,000 as soon as possible after the RFC loan was repaid (R. 18). Respondent's argument is that the redemption was simply a consummation of the original understanding, and, therefore, the redemption had a business purpose. This argument is based on the premise that the circumstances surrounding the issuance of his preferred stock were somehow different from those present in the typical investment situation, and thus merit special treatment. Quite the contrary is true, however. Respondent did what every organizer of a corporation must do—provide in one way or another the capital necessary to get a new business underway. It appears that the re-

Keefe v. *Cote* and in *Estate of Henry A. Golwynne* v. *Commissioner*, 26 T.C. 1209, and *Herzog* v. *Commissioner*, decided November 4, 1963, 22 T.C.M. 1595, which relied upon it, the courts cited as critical to the decisions a factor not present here. In each, the preferred stock redeemed had originally been issued in exchange for debts which in turn had been created in favor of the taxpayer in exchange for services performed and in lieu of cash payments. The courts noted that the amount of the debts had previously been reported as compensation income by the taxpayers in the year created, although no cash had been received. They concluded, therefore, that treatment of the distributions as dividends when the preferred stock was retired would be tantamount to taxing the shareholder twice on a single withdrawal from the corporation. While we do not agree that these cases were correctly decided—the taxpayers were in no different a position than they would have been had they originally received cash for their services and thereafter acquired preferred stock—the cases plainly have no bearing on the business purpose question presented here.

quired capital here was about $115,000—$20,000 for machinery and a foundry to be erected at a cost of $95,000 (R. 15–16, 18). Had the Tennessee Foundry organizers (respondent and Bradley) initially contributed in exchange for stock the full $115,000 of capital needed, there presumably would be no claim for special treatment. However, as is true of many, if not most, of the organizers of small corporations, they wished to accomplish their purposes by making a minimum investment of risk capital—in this case $20,000—and borrowing the balance. As frequently happens, the lender demanded that additional capital be added to the corporation. Respondent and Bradley thus found that the minimum capital investment necessary was $45,000, not $20,000 as they had hoped, and, accordingly, they arranged between them to furnish the required amount. Having done so, they were in the same position as any other corporate investors and subject to the same tax rules with respect to subsequent distributions.

The fact is that the funds advanced in exchange for *both* the common and preferred stock were advanced for the same "business" reason as is the equity of any corporation—to provide necessary capital. It was immaterial to RFC how the capital structure of the corporation was arranged so long as its minimum capital requirement was met. Since the common stock investment was as necessary to meet this minimum requirement as the preferred stock investment, respondent might as well have used this investment history as a basis for redeeming his common shares as the preferred. If the mere fact that a given invest-

ment was made reluctantly and only because the investment was necessary to get the business started is enough to avoid dividend equivalence upon the redemption of the stock associated with that investment, virtually all redemptions by closely held corporations would qualify for the treatment claimed here, and the statutory rules governing distributions to shareholders of such corporations would, as a practical matter, be suspended.

Respondent's argument that the redemption had a business purpose because it was the consummation of the original understanding leads to an unreasonable disparity in tax treatment between similarly situated taxpayers. It would grant a tax privilege to some shareholders simply because they formulated an intention to redeem their stock when the stock was issued. Other shareholders, who also invested their money for legitimate reasons but only later decided to withdraw their investment, would pay a higher tax. We know of no authority or policy that would support or justify such a difference in the tax treatment of corporate shareholders.

What respondent is asking is that his preferred stock be treated as debt even though it was not debt.[22] He says as much in his brief in opposition (p. 3): "Here, moreover, there was a clearly identifiable date as of which the preferred stock was to be redeemed—the date of payment in full of the RFC debt. In this

[22] In his affidavit of October 19, 1966, respondent stated (R. 9), "I decided to purchase preferred stock because I was told that this would be preferable [to debt] from the standpoint of the corporation's balance sheet."

respect the preferred stock was like a subordinated debt." [23] Had respondent loaned the $25,000 to Tennessee Foundry, as he could have done (R. 9, 29), he might have been entitled, upon repayment of the loan, to the tax treatment granted him by the court of appeals.[24] But he chose instead to furnish additional equity capital and, having done so, must be taxed in accordance with the rules applicable to equity capital. As the Second Circuit has observed, "It would be quite intolerable to pyramid the existing complexities of tax law by a rule that the tax shall be that resulting from the form of transaction taxpayers have chosen or from any other form they might have chosen, whichever is less." *Television Industries, Inc.* v. *Commissioner,* 284 F. 2d 322, 325. Respondent cannot now claim the more favorable tax treatment that might have been available if the transaction had been framed differently.

There is, in sum, no justification for looking "to the point in time when [respondent] contributed the $25,000" (R. 44); nor is there a business purpose for the redemption because Tennessee Foundry "had always intended to redeem [respondent's] preferred

[23] The Sixth Circuit's statement (R. 44) that the government was attempting to preclude respondent "from withdrawing his $25,000 investment intact" also suggests that the court was treating the investment as if it were debt rather than equity capital.

[24] This would have depended on whether, notwithstanding respondent's labeling of his additional investment as debt, the investment in fact constituted equity because the $25,000, like the capital represented by the common stock, was at the general risk of the business. See, *e.g.*, *Gilbert* v. *Commissioner*, 262 F. 2d 512 (C.A. 2), certiorari denied, 359 U.S. 1002.

stock when the [RFC] loan was paid off" (*ibid.*).[25] It is true that if respondent's preferred stock had been redeemed before he acquired Bradley's common stock, the redemption would have qualified for capital gains treatment.[26] This result would have been proper, however, not because it was the consummation of the parties' original understanding, as the Sixth Circuit assumed (R. 44–46), but because it would have resulted in an exchange of property for cash. Contrary to the court of appeals' statement (R. 44–45), we do not say that respondent's acquisition of all of Bradley's stock "* * * converted what would have been a straight stock redemption into a tax-avoidance scheme to bail out corporate earnings." We do say, however, that the acquisition rendered any redemption of respondent's stock meaningless because, thereafter, respondent was the owner, actual or constructive, of all of the rights of complete ownership of Tennessee Foundry, and it no longer mattered by what type or form of stock, or number of shares, that interest was represented. The parties' original understanding, that the stock would be redeemed when the RFC loan was

[25] Respondent did suggest (R. 17) that the redemption served the business purpose of relieving Tennessee Foundry of the burden of paying the annual six percent dividend on the preferred stock. However, as was pointed out in *Ballenger* v. *United States*, *supra*, at 199, this objective could have been achieved, without redeeming respondent's preferred stock, simply by converting that stock into common stock. It could also have been achieved by a simple surrender of the preferred shares without any cash distribution.

[26] This is what the Internal Revenue Service held in a case remarkably similar to this one. Rev. Rul. 55–462, 1955–2 Cum. Bull. 221. Compare Rev. Rul. 56–265, 1956–1 Cum. Bull. 156.

paid off, was as irrelevant to the dividend equivalence question following respondent's "decision to buy out Bradley's interest and acquire control of the corporation" (R. 44) as it had been previously.

Thus, even if business purpose can prevent a redemption from being essentially equivalent to a dividend, no showing of such a purpose for the redemption has been made here. The fact is that the $25,000 was distributed to respondent in redemption of his preferred stock because it was, in respondent's words, "surplus money" (R. 17). The distribution of "surplus money" to the sole shareholder of a corporation is precisely the kind of distribution to which the dividend rules of Section 301 and 316 are designed to apply.

III. RESPONDENT WAS THE ACTUAL OR CONSTRUCTIVE OWNER OF ALL OF TENNESSEE FOUNDRY'S STOCK IMMEDIATELY BEFORE AND AFTER THE REDEMPTION

Immediately prior to the redemption here in issue, respondent owned all of Tennessee Foundry's preferred stock and 25 percent of its common stock. His wife and children owned all of the remaining common stock. The ownership interests remained the same after the redemption except that the preferred stock was eliminated.

Both courts below held that in deciding the ultimate question presented in this case—whether the $25,000 distribution to respondent was essentially equivalent to a dividend—respondent must be considered the owner of the Tennessee Foundry common stock actually owned by his wife and children. Specifically,

it was held that Section 302(c)(1) required the application of the statutory rules of stock attribution prescribed in Section 318. The courts accordingly treated respondent as the sole owner of Tennessee Foundry's stock immediately before and after the redemption for the purpose of determining dividend equivalence under Section 302(b)(1). Since respondent referred to the attribution issue in his brief in opposition (pp. 3–5) and presumably will seek to support the judgment below on the ground that this issue was decided erroneously, we deal with it here.

Section 318(a)(1)(A) provides that "For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable * * * [a]n individual shall be considered as owning the stock owned * * * by * * * his spouse * * * and * * * his children * * *." Thus, if Section 318(a)(1)(A) applies in this case, respondent would be deemed the owner of all of Tennessee Foundry's stock immediately before and after the redemption; and, for purposes of determining dividend equivalence under Section 302(b)(1), the distribution to him in redemption of his preferred stock would have to be considered a pro rata distribution. We submit that both courts below correctly held that Section 302(b)(1) is one "of those provisions" to which the attribution rules of Section 318(a)(1)(A) "are expressly made applicable."

Section 318(b)(1) of the Code, which is a cross reference section, provides that "For provisions to which the rules contained in subsection (a) [of Section 318] apply, see * * * Section 302 (relating to redemption

of stock) * * *." Section 302(c)(1) in turn provides that "Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section." There is no exception in paragraph (2) of Section 302(c) relating to distributions subject to Section 302 (b)(1). The exceptions enumerated in that paragraph apply only to cases arising under Section 302(b)(3) which involves redemptions in complete termination of a shareholder's interest.

Section 302(c)(1) is susceptible of only one interpretation—and that is that the statutory attribution rules do apply in determining dividend equivalence under Section 302(b)(1). Section 302(c)(1) does not say that these rules apply in determining stock ownership "for purposes of this section other than subsection 302(b)(1)" or that the rules "may" apply in determining stock ownership. It says that the rules "shall apply * * * for purposes of this section" (302), which includes subsection 302(b)(1). That Congress meant what it said is confirmed by the legislative history. Thus, the Senate Finance Committee, which added Section 302(b)(1) to H.R. 8300 (see p. 18, *supra*), stated that Section 302(c) "provides rules for determination of the constructive ownership of stock for the purpose of section 302." S. Rep. No. 1622, 83d Cong., 2d Sess., 235. There is no legislative history to the contrary.[27]

[27] The Finance Committee's explanation (S. Rep. No. 1622, *supra*, at 233) that, by adding Section 302(b)(1) to the House bill, it intended "to revert in part to existing [1939 Code] law" (which did not include statutory attribution rules) can hardly be taken to mean that the attribution rules are not applicable

In addition to the Sixth Circuit, four other courts of appeals have considered the question whether the constructive ownership provisions apply in determining dividend equivalence under Section 302(b)(1). All of them have answered the question affirmatively. *Bradbury* v. *Commissioner,* 298 F. 2d 111, 116–117 (C.A. 1); *Levin* v. *Commissioner,* 385 F. 2d 521, 526–527 (C.A. 2); *Ballenger* v. *United States,* 301 F. 2d 192, 199 (C.A. 4); *Commissioner* v. *Berenbaum,* 369 F. 2d 337, 342 (C.A. 10).

Section 1.302–2(b) of the Income Tax Regulations (1954 Code) explicitly provides that constructive stock ownership under Section 318(a) is one of the facts to be considered in determining dividend equivalence under Section 302(b)(1). In arguing below that Section 318(a) does not apply in this case, respondent was, in effect, seeking a judicial invalidation of the applicable Treasury Regulations even though "it is reasonable to apply [the attribution rules] whenever ownership of stock is relevant." Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed. 1966) 292 n. 32. On numerous occasions, however, this Court has held that "* * * Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty

in Section 302(b)(1) cases. The Committee's explicit statement quoted in the text leaves no room for doubt as to the scope of Section 302(c)(1).

reasons." *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501. No such reasons are present in this case.

Respondent's principal argument below was that because Section 302(c)(1) makes the attribution rules applicable "in determining the ownership of stock," Section 318(a) is intended to apply only to redemptions described in Section 302(b) (2) and (3) wherein stock ownership is expressly mentioned. This argument ignores the plain language of Section 302(c)(1), discussed above. It also ignores the fact that the applicability of Section 302(b)(1), like that of Sections 302(b) (2) and (3), depends upon a comparison of the taxpayer's percentage of stock ownership before and after a redemption. The only difference is that the latter provisions give specific rules for determining what constitutes an exchange entitling the taxpayer to capital gains treatment, while the former provision does not. Moreover, to interpret Section 302(c) in the manner urged by respondent would deprive the attribution rules of much of their significance. Under such an interpretation, a taxpayer who failed to meet the specific tests of Sections 302(b) (2) or (3) only because of the attribution rules, would qualify for favorable tax treatment under Section 302(b)(1) despite those rules.[28]

Similarly lacking in merit is the alternative contention advanced by respondent below that if the attribution rules are applicable at all to Section 302(b)(1)

[28] A redemption not qualifying for favorable treatment under Sections 302(b) (2) or (3) for reasons other than the attribution rules could still qualify for such treatment under Section 302(b)(1), if the attribution rules did not make the redemption essentially equivalent to a dividend.

cases, their application is not mandatory, as it is in cases arising under Section 302(b) (2) and (3), but optional. Under this theory, which presumably is based on the Second Circuit's dictum in *Levin* v. *Commissioner, supra* at 526 n. 21, a court is free not to apply the attribution rules in Section 302(b)(1) cases when it feels that their application would be inappropriate.[29]

This argument, like respondent's principal argument, appears to be inconsistent with the plain language of the statute. Furthermore, it has never been suggested, except in a case where the family members involved were hostile to one another, that it would be inappropriate to apply the attribution rules. See Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders, supra* at 292. Respondent has neither alleged nor shown that any hostility existed between him and his wife and children, so that, for present purposes, the question whether a "family hostility" exception exists under Section 302(b)(1) is entirely academic.

Since the statutory attribution rules clearly apply in this case, the courts below were correct in holding that in determining the ultimate question of dividend equivalence under Section 302(b)(1), respondent must be regarded as the sole owner of all of Tennessee Foundry's stock immediately before and after the redemption, and that his proportionate ownership interest was not changed by the redemption.

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[29] Compare *Estate of Arthur H. Squier* v. *Commissioner*, 35 T.C. 950, *acquiescence* 1961-2 Cum. Bull. 5.

CONCLUSION

The judgment of the court of appeals should be reversed and the cause remanded to the district court with directions to dismiss the complaint.

Respectfully submitted.

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DECEMBER 1969.

APPENDIX

Statutes and Regulation Involved

Internal Revenue Code of 1954:

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) *In General.*—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * *

(c) *Amount Taxable.*—In the case of a distribution to which subsection (a) applies—

(1) *Amount constituting dividend.*—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

* * * * *

[26 U.S.C. Sec. 301.]

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) *General Rule.*—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated as Exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) *Substantially disproportionate redemption of stock.*—

(A) *In general.*—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) *Limitation.*—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) *Definitions.*—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) *Series of redemptions.*—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) *Termination of shareholder's interest.*—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) *Stock issued by railroad corporations in certain reorganizations.*—Subsection (a) shall apply if the redemption is of stock issued by a

railroad corporation (as defined in section 77 (m) of the Bankruptcy Act, as amended) pursuant to a plan of reorganization under section 77 of the Bankruptcy Act.

(5) *Application of paragraphs.*—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c)(2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

(c) *Constructive Ownership of Stock.*—

(1) *In general.*—Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section.

(2) *For determining termination of interest.*—

(A) In the case of a distribution described in subsection (b) (3), section 318(a)(1) shall not apply if—

(i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,

(ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and

(iii) the distributee, at such time and in such manner as the Secretary or his delegate by regulations prescribes, files an agreement to notify the Secretary or his delegate of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

If the distributee acquires such an interest in the corporation (other than by bequest or inheritance) within 10 years from the date of the distribution, then the periods of limitation provided in sections 6501, and 6502 on the making of an assessment and the collection by levy or a proceeding in court shall, with respect to any deficiency (including interest and additions to the tax) resulting from such acquisition include one year immediately following the date on which the distributee (in accordance with regulations prescribed by the Secretary or his delegate) notifies the Secretary or his delegate of such acquisition; and such assessment and collection may be made notwithstanding any provision of law or rule of law which otherwise would prevent such assessment and collection.

(B) Subparagraph (A) of this paragraph shall not apply if—

(i) any portion of the stock redeemed was acquired, directly or indirectly, within the 10-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318(a), or

(ii) any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under section 318(a) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the 10-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction.

The preceding sentence shall not apply if the acquisition (or, in the case of clause (ii), the disposition) by the distributee did not have as one of its principal purposes the avoidance of Federal income tax.

(d) *Redemptions Treated as Distributions of Property.*—Except as otherwise provided in this subchapter, if a corporation redeems its

stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

* * * * *

[26 U.S.C. 302.]

* * * * *

SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

* * * * *

[26 U.S.C. 316.]

* * * * *

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK.

(a) *General Rules.*—For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

(1) *Members of family.*—

(A) *In general.*—An individual shall be con-

sidered as owning the stock owned, directly or indirectly, by or for—

(i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and

(ii) his children, grandchildren, and parents.

(B) *Effect of adoption.*—For purposes of subparagraph (A)(ii), a legally adopted child of an individual shall be treated as a child of such individual by blood.

* * * * *

(b) *Cross References.*—

For provisions to which the rules contained in subsection (a) apply, see—

(1) section 302 (relating to redemption of stock);

* * * * *

[26 U.S.C. 318.]

Treasury Regulations on Income Tax (1954 Code):

§ 1.302–2 Redemptions not taxable as dividends.

(a) The fact that a redemption fails to meet the requirements of paragraph (2), (3) or (4) of section 302(b) shall not be taken into account in determining whether the redemption is not essentially equivalent to a dividend under section 302(b)(1). See, however, paragraph (b) of this section. For example, if a shareholder owns only nonvoting stock of a corporation which is not section 306 stock and which is limited and preferred as to dividends and in liquidation, and one-half of such stock is redeemed, the distribution will ordinarily meet the requirements of paragraph (1) of section 302(b) but will not meet the requirements of paragraph (2), (3) or (4) of such section. The determination of whether or not a distribution is within the phrase "essentially equivalent to a dividend" (that is, having the same effect as a distribution without any redemption of stock) shall be made without regard to the earnings and

profits of the corporation at the time of the distribution. For example, if A owns all the stock of a corporation and the corporation redeems part of his stock at a time when it has no earnings and profits, the distribution shall be treated as a distribution under section 301 pursuant to section 302(d).

(b) The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a). All distributions in pro rata redemptions of a part of the stock of a corporation generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding. However, for distributions in partial liquidation, see section 346. The redemption of all of one class of stock (except section 306 stock) either at one time or in a series of redemptions generally will be considered as a distribution under section 301 if all classes of stock outstanding at the time of the redemption are held in the same proportion. Distribution in redemption of stock may be treated as distributions under section 301 regardless of the provisions of the stock certificate and regardless of whether all stock being redeemed was acquired by the stockholders from whom the stock was redeemed by purchase or otherwise. In every case in which a shareholder transfers stock to the corporation which issued such stock in exchange for property, the facts and circumstances shall be reported on his return except as provided in paragraph (d) of § 1.331–1. See sections 346(a) and 6043 for requirements relating to returns by corporations.

(c) In any case in which an amount received in redemption of stock is treated as a distribu-

tion of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed. The following examples illustrate the application of this rule:

* * * * *

[26 C.F.R. 1.302–2.]

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1969

No. 282

UNITED STATES OF AMERICA,
Petitioner,

vs.

MACLIN P. DAVIS and EDITH U. DAVIS,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

~~REPLY~~ BRIEF FOR MACLIN P. DAVIS AND EDITH U. DAVIS

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1969

No. 282

UNITED STATES OF AMERICA,
Petitioner,

vs.

MACLIN P. DAVIS and EDITH U. DAVIS,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR MACLIN P. DAVIS AND EDITH U. DAVIS

QUESTION PRESENTED

Respondent* would rephrase the question presented as follows:

*As in petitioner's brief, Maclin P. Davis will be referred to as the respondent, since his wife is a party only because a joint income tax return was filed.

Whether the redemption by a corporation of preferred stock originally issued for cash in order to enable the corporation to obtain a loan, with the understanding that it would be redeemed when the loan was paid, was essentially equivalent to a dividend within Section 302(b)(1) of the Internal Revenue Code, solely by reason of (1) the existence of earnings and profits, and (2) the fact that after the preferred stock was purchased, the taxpayer purchased from another stockholder, and gave to two adult children, all the common stock not already owned by himself and his wife, and that he and his wife and children continued to own the common stock until the redemption of the preferred stock took place.

STATEMENT

Petitioner's statement in its brief follows the statement contained in the petition for certiorari in omitting the significant fact that the Tennessee Foundry & Machine Company had always intended to redeem the preferred stock when the RFC loan was paid off, and that the redemption was simply the final step taken in completion of the original purpose to provide working capital while the RFC loan was in effect, but no longer. (R. 9). It also omits to state, as did the petition itself, that the funds with which the preferred stock were redeemed were "surplus money"; that the corporation had the "cash in the bank" and was "paying 6% on it" [the preferred stock]; and that at the time Mr. Davis gave his discovery deposition more than three years later, the corporation had not "borrowed money from anybody." (R. 17-18).

STATUTE INVOLVED

Internal Revenue Code of 1954:

Sec. 302. Distributions in Redemption of Stock.

(a) *General Rule.*—If a corporation redeems its stock (within the meaning of section 317 (b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated as Exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

ARGUMENT

A Return of Capital Is Not "Income" Within the Sixteenth Amendment.

If Section 302 of the Internal Revenue Code could be construed as levying an income tax on the proceeds of the redemption in this case, it would be unconstitutional. The Sixteenth Amendment provides:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

Petitioner has cited the landmark case of *Eisner* v. *Macomber,* 252 U.S. 189. The following paragraph from the opinion (p. 206) is pertinent here:

> "In order, therefore, that the clauses cited from Article I of the Constitution[1] may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

In considering what constituted "income," the Court in *Eisner* v. *Macomber* said (p. 206) that what was required was "only a clear definition of the term 'income,' as used in common speech, in order to determine its meaning in the Amendment; . . ." The Court then cited *Doyle* v. *Mitchell Brothers Co.*, 247 U.S. 179, involving the Corporate Tax Act of August 5, 1909, levying an excise tax on corporations, measured by "net income." The Court there held that in computing net income from the conversion of timber into lumber, the taxpayer was entitled to deduct from gross receipts the valuation (on the day before the effective date of the Act) of the stumpage cut and so converted, saying (p. 185):

> ". . . In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

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1. Article I, Section 2, clause 3, providing that "direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers," and Article I, Section 9, clause 4, providing: "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."

That the redemption proceeds of the preferred stock in the instant case were not income "according to truth and substance," and "as used in common speech," cannot be doubted. Respondent got back from the corporation in exchange for his preferred stock exactly what he paid in for the preferred stock,—no more and no less. A simpler illustration of a return of capital could not be imagined. This proposition would, indeed, not be questioned by petitioner were it not for the attribution rules of Section 318 of the Internal Revenue Code. We shall, later on, attempt to show that Congress did not intend these rules to be applicable in a situation such as here presented; but if Congress did so intend, it has disregarded "truth and substance." The Code, so construed and applied, runs afoul of Article I, § 2, cl. 3 and § 9, cl. 4 of the Constitution, because the tax is a direct tax which has not been apportioned among the states according to population, and it is not saved by the Sixteenth Amendment because it is not upon "income."

There was, in the instant case, a clearly identifiable date as of which the preferred stock was to be redeemed—the date of payment in full of the RFC debt,—so that the preferred stock had some of the characteristics of subordinated debt.[2] In considering whether there was a return of capital or a distribution of earnings and profits, the entire transaction, and not merely the last prong of

2. Petitioner belittles this point in its brief (pp. 29-30). However, at least four Tax Court judges recently expressed the view that dividends on preferred stock should be deductible as interest where there was an agreement to redeem. *Ragland Investment Co.*, 52 T.C. No. 92, filed August 26, 1969. We make no such contention here, but merely suggest the analogy, in a case involving dividend equivalence, between subordinated debt and preferred stock, where there is an understanding or agreement for its redemption.

a two-pronged transaction must be considered.[3] Even if the respondent in this case had actually owned all the common stock of the corporation from the beginning, the redemption of the preferred stock would have been a simple return of capital, not taxable as income under the Constitution.

Business Purpose and Absence of a Tax Avoidance Purpose

Petitioner's argument is that respondent constructively owned all the stock of the corporation, and that the redemption of any part of the stock of a sole owner is essentially equivalent to distribution of a taxable dividend to the extent of the corporation's earnings and profits, irrespective of business purpose and of absence of a tax avoidance purpose. In support of this theory petitioner (p. 18), quotes two sentences (relating to Section 302(b)(1) of the new 1954 Internal Revenue Code) from the Senate Finance Committee Report (S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 44-45)[4] as follows:

> ". . . While the House bill set forth definite conditions under which stock may be redeemed at capital-gain rates, these rules appeared unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place.[5] Accordingly, your committee follows existing law by reinserting the gen-

3. *Keefe* v. *Cote*, 213 F. 2d 651 (C.A. 1); *Cobb* v. *Callan Court Company*, 274 F. 2d 532 (C.A. 5); *Colvin* v. *United States*, 175 F. Supp. 877 (S.D. Calif.); *Estate of Henry A. Golwynne*, 26 T.C. 1209; *Joe L. Smith, Jr., et ux.* v. *Commissioner*, 49 T.C. 476; *Robert H. Herzog*, T.C. Memo. 1963-303, 22 T.C.M. 1595.

4. 3 U. S. Code Cong. & Adm. News, 83rd Cong. (2d Sess.) 1954, p. 4675.

5. In this case Davis, the holder of the preferred stock, owned only one-fourth of the common stock,—the attribution rules aside.

eral language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend. . . ."

From the word "particularly," and the clause immediately following, petitioner draws the conclusion that the Senate Committee intended Section 302(b)(1) to have a "narrow application." Petitioner cites in a footnote (Footnote 15, p. 18) Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, 2d Edition 1966, 291, to the effect that (based on the same word and clause) the provision's "major function was the narrow one of immunizing redemptions of minority holdings of preferred stock." It is difficult to follow this argument in view of the very next sentence in the Committee Report and of the lengthy explanation found in "Detailed Discussion of the Technical Provisions of the Bill,"[6] hereinafter referred to, which make it plain that Section 302(b)(1) was intended to follow "existing law" as developed under Section 115(g)(1) of the Internal Revenue Code of 1939 and its predecessor provisions. In the Detailed Explanation nothing further is said about redemptions of minority holdings of preferred stock, as we shall see.

The petitioner, in its brief (pp. 20-21) cites the legislative history of Section 201(g) of the Revenue Act of 1926 (the predecessor of Section 115(g)(1)), and argues that the courts between 1926 and 1954 disregarded this legislative history. But all that the Committee Reports were there attempting to explain was the inclusion in Section 201(g) of the parenthetical phrase "(whether or not such stock was issued as a stock dividend)." Under Section 201(f) of the 1924 Act (the corresponding provision), redemptions had not been treated as dividend distributions

6. 3 U. S. Code Cong. & Adm. News, 83 Cong. (2d Sess.) 1954, p. 4870.

unless they took place before or after the distribution of a stock dividend. The 1926 amendment made no change, however, in the former language that the redemption was taxable only if "essentially equivalent to the distribution of a taxable dividend," and only "to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913."

In arguing that business purpose and absence of a tax avoidance purpose were irrelevant under Section 201(g), as amended in 1926, petitioner apparently takes the position that Congress intended to impose an automatic dividend such as was imposed in Section 203(d)(2), relating to "boot" in reorganization exchanges. The contrast in language, however, is striking. In Section 203(d)(2) the phrase used was "has the effect of the distribution of a taxable dividend."[7] Moreover, the distribution was not required to "represent" a distribution of earnings and profits. The mere existence of earnings and profits was enough, and dividend treatment was automatic, provided there was "gain." It was so held in *Commissioner* v. *Estate of Bedford*, 325 U.S. 283. The failure to recognize the differences between these two sections may have given birth to the so-called "strict net effect" rule in connection with redemptions.[8]

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7. Section 203(d)(2) of the 1926 Act became Section 112(c)(2) of the 1939 Code and Section 356(a)(2) of the 1954 Code. It is clear that two essentially non-equivalent acts may have the identical "effect."

8. In *Commissioner of Internal Revenue* v. *Snite*, 177 F. 2d 819 (C.A. 7), the Commissioner relied upon *Estate of Bedford* in a redemption case, citing *Kirschenbaum* v. *Commissioner*, 155 F. 2d 23 (C.A. 2), where the Second Circuit construed *Estate of Bedford* as overruling an earlier Second Circuit doctrine that "redemption of shares can never be 'essentially equivalent' to the payment of a dividend if the shares were originally issued for a bona fide corporate purpose." This Court in *Estate of Bedford* had reversed *Bedford's Estate* v. *Commissioner*, 144 F. 2d 272 (C.A. 2). As correctly held in *Snite*, while the Second Circuit's former interpretation was in error, *Estate of Bedford* was in no wise controlling. The Second Circuit's earlier error had been with respect

The House Ways and Means Committee Report (H. Rep. No. 1, 69th Cong., 1st Sess., p. 5), referred to in petitioner's brief (pp. 20-21), indicated that the 1926 amendment had the narrow purpose of closing a tax avoidance loophole under which stockholders could withdraw earnings and profits by the device of a pro rata sale to the corporation of part of their stock for redemption. We are not concerned in the instant case with business purpose in connection with a pro rata redemption of common stock, or of preferred stock originally issued in the tax-free incorporation of a business, or in exchange for common stock in a recapitalization. We are concerned with preferred stock originally issued for cash; and there is nothing in the Report to suggest that the redemption of such preferred stock was to be treated as the payment of a dividend merely because it is pro rata. Of course, redemptions of preferred stock originally issued as a stock dividend were covered both before and after the 1926 amendment.

After arguing that the "numerous decisions"[9] under Section 115(g) of the 1939 Code and its predecessor provisions were "wrongly decided," on the ground that they ignored the legislative history of the 1926 Act (Brief, p. 20), the petitioner next argues that Section 302(b)(1) of the 1954 Code changed "existing law"[10] because it omitted the phrase "at such time and in such manner" contained in Section 115(g). (Brief, pp. 21-22). But when we look

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to redemptions of shares originally issued as stock dividends to capitalize accumulated earnings and profits; and the Court overreacted to this Court's reversal of its decision in *Bedford's Estate*. See *Levin* v. *Commissioner of Internal Revenue*, 385 F. 2d 521, 523-4 (C.A. 2), in which the Court adheres to its erroneous view that *Estate of Bedford* overruled its earlier cases.

9. The most recent of these cases prior to the enactment of the 1954 Code was *Keefe* v. *Cote*, 213 F. 2d 651 (C.A. 1), decided June 18, 1954.

10. As to petitioner's argument on corporate contraction (p. 22, footnote 19), see our footnote 11, infra, p. 12.

at the legislative history of Section 302(b)(1), there is nothing in any committee report to suggest that the phrase "at such time and in such manner" was omitted for any reason other than the obvious reason that it was superfluous and redundant. The Senate Committee's language was to the effect that in reverting to the "essentially equivalent" test, it was not changing but (at least "in general") was incorporating "existing law." The abbreviation of the language used was of no significance. In its "Detailed Discussion of the Technical Provisions of the Bill," the Committee said:

> "Section 302 corresponds in function to section 302 of the House bill and relates to section 115(c), (g), and (i) of the 1939 Code. Under this section, rules are prescribed for the tax treatment to shareholders receiving distributions of property in redemption of stock. As under section 302 of the House bill, distributions in redemption of stock which qualify as distributions in complete or partial liquidations under part II of subchapter C are not within the scope of section 302. Unlike the House bill, however, section 302 does not provide specific statutory guides governing the tax consequences of every stock redemption. In lieu of the approach in the House bill, your committee intends to revert in part to existing law by making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, except where it is specifically provided otherwise, upon a factual inquiry. For special rules relating to the redemption of section 306 stock, see the discussion under section 306."

And again:

> "Subsection (b) of section 302 states three conditions in paragraphs (1), (2), (3), and (4), the satisfaction of any one of which will result in the treat-

ment of the redemption as a distribution in full or part payment in exchange for the stock. In general, under this subsection your committee intends to incorporate into the bill existing law as to whether or not a reduction [sic] is essentially equivalent to a dividend under section 115(g) (1) of the 1939 Code, and in addition to provide three definite standards in order to provide certainty in specific instances."

And again:

"The test intended to be incorporated in the interpretation of paragraph (1) is in general that currently employed under section 115(g) (1) of the 1939 Code. Your committee further intends that in applying this test for the future that the inquiry will be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation. For this purpose the presence or absence of earnings and profits of the corporation is not material. Example: X, the sole shareholder of a corporation having no earnings or profits causes the corporation to redeem half of its stock. Paragraph (1) does not apply to such redemption notwithstanding the absence of earnings and profits. The fact that the proceeds of the redemption are not taxable as ordinary income to X results through application of section 302(d) and section 301."

Petitioner stresses (p. 19) the second sentence in the last paragraph above quoted. Petitioner asserts that a sale results in a reduction of the shareholder's proportionate interest, while a dividend does not; points out that a sale to the corporation of stock for redemption by a *sole* stockholder cannot reduce such sole stockholder's proportionate interest; and draws the conclusion that what appears to be a sale by a sole stockholder cannot, therefore, be a sale, but only a redemption essentially equiva-

lent to a dividend, because of the original hypothesis that a sale must reduce the stockholder's proportionate interest. This is the well-known fallacy of the ambiguous middle. A "sale" to a third person and a "sale" to the corporation are two different things.

It has been previously noted that the Senate Committee Report expresses the intention that existing law be followed "in general." One plausible explanation for this phrase is that corporate contraction may be no longer a criterion as it was under the 1939 Code.[11] In addition, the statement that "presence or absence of earnings and profits is not material" was apparently a complete rejection of the "net effect" criterion where business purpose and absence of tax avoidance purpose are found, as in the instant case.[12]

Petitioner argues, however (pp. 24-25), that Section 306 of the 1954 Code, relating to preferred stock "bail outs," specifically excepted from its provisions a disposition of preferred stock when it "was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax." The petitioner's argument is that this specific exception in Section 306 implied an in-

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11. See *J. Milton Sorem*, 40 T.C. 206, 218-219 (reversed 334 F. 2d 275 (C.A. 10)) where Judge Dawson, in a dissenting opinion, explains that "corporate contraction, as a measure of dividend equivalency, is now pertinent only to section 346, and has no meaning with regard to section 302." See also *Oscar E. Baan*, 51 T.C. 1032, where the Court, under the caption "II. Applicability of Section 346," remarks: "Further, the test of section 346(b)—the cessation of an active business—was *prior to the 1954 Code* a major judicial test for determining whether a distribution was 'essentially equivalent to a dividend' under section 115(g) of the 1939 Code." (Emphasis supplied).

12. New York University Institute on Federal Taxation, Thirteenth Annual (1955), pp. 547, 549-50 (Stephen T. Dean on Stock Redemptions); ibid., Fourteenth Annual (1956), pp. 671, 686 (George J. Laikin on Stock Redemptions).

tention that absence of a tax avoidance purpose was to be irrelevant under Section 302(b)(1). But Section 306 was new, while Section 302(b)(1), as we have seen, was intended to incorporate "existing law," so that it was unnecessary for Congress to spell out what "existing law" embodied. It is undisputed that business purpose and absence of a tax avoidance purpose were considered by most courts in applying Section 115(g)(1) of the 1939 Code and predecessor provisions; and this was known to the Treasury and the Senate Committee. Petitioner merely argues that these decisions were wrong.

Attribution Rules: The Congressional Intent

Section 302(c)(1) of the 1954 Code provides that, with exceptions not here material, "section 318(a) shall apply in determining the ownership of stock for purposes of this section." Section 302(b)(1) is a part of "this section," and for that reason the petitioner argues that respondent was the constructive owner of the common stock of his wife and two adult children, and for purposes of this case the sole owner of the stock of Tennessee Foundry & Machine Company. We believe that petitioner gives too much meaning to the words "for purposes of this section" and that what Congress intended was that Section 318(a) should apply for the purposes of those provisions of the section where ownership of stock is mentioned, viz., paragraph (2) of subsection (b) relating to substantially disproportionate redemptions, and paragraph (3) of subsection (b) relating to termination of a shareholder's interest.[13] We think that the legislative history demonstrates

13. See The Internal Revenue Code of 1954: Corporate Distributions, Organizations and Reorganizations, 68 Harvard Law Review 393, by Edwin S. Cohen and others, footnote 38, p. 398, and footnote 51, p. 400; cf. Guide to the Internal Revenue Code of 1954, 1 U. S. Code Cong. & Adm. News, 84th Cong. (1st Sess. 1955), pp. 1183, 1274-5, where there is no mention of the attribution rules in connection with Section 302(b)(1).

that such was the intention, especially when the sequence of events is considered by which the "essentially equivalent" test became belatedly incorporated into the bill which was finally enacted into law.

As the bill came from the House to the Senate, the attribution rules were in Section 311 rather than 318, and Section 302 did not include the "essentially equivalent" test.[14] It did include, in substance, the provisions which became paragraphs (2) and (3) of subsection (b), with the provision that Section 311 should be "applicable in determining the ownership of stock." The mechanical tests based on ownership and the attribution rules were wrapped up in a single package, which did not include the old "essentially equivalent" test. But the Senate Committee thought the House bill unnecessarily restrictive and added, in substance, old Section 115(g)(1), while retaining the provision relating to the attribution rules exactly where it was found. It is reasonable to assume, therefore, that the Senate Committee intended for the attribution rules to be applicable only where they would have been applicable if the House bill had been adopted without the addition of the "essentially equivalent" test.

This conclusion is fortified by the fact that nowhere in the Senate Committee Report,—either the preliminary portion[15] or the Detailed Explanation,[16]—was there any mention whatever of attribution rules in connection with the "essentially equivalent" test of Section 302(b)(1). Although it was stated several times that the Committee

14. H.R. 8300 "A Bill to Revise the Internal Revenue Laws of the United States"; House Report No. 1337, 3 U. S. Code Cong. & Adm. News, 83d Cong. (2d Sess.) 1954, pp. 4025, 4060-1.

15. 3 U. S. Code Cong. & Adm. News, 83d Cong. (2d Sess.) 1954, pp. 4623, 4684-6.

16. Ibid. pp. 4793, 4867-4874.

intended to revert to "existing law," there was no qualification of this statement by reference to the attribution rules. On the other hand, in the explanation of paragraph (2) of subsection (b), (the substantially disproportionate test), it is said: "In determining the ownership of stock, subsection (c) makes clear that the rules of constructive ownership provided in section 318 are applicable." And in the explanation of paragraph (3), (the termination of interest test), it is said: "This paragraph must be read in connection with the provisions of subsection (c) of section 302 relating to constructive ownership of stock."[17]

In determining the intention of Congress, it is significant that paragragh (5) of Section 302(b) of the Code, as finally enacted, states that failure "to meet the requirements of paragraph (2), (3) or (4) shall not be taken into account" in determining whether the requirements of paragraph (1) are met. Let us suppose a case where the failure to meet the requirements of paragraph (2) or (3) is solely because of the attribution rules. In such a case, if the attribution rules are also "taken into account" with respect to paragraph (1), it is clear that the mandate of paragraph (5) has been disobeyed. This demonstrates that Congress did not intend for the attribution rules to be "taken into account" in determining whether the requirements of paragraph (1) are met.

The argument is clinched, we submit, by the following sentence in the preliminary Senate Report, following the brief discussion of the substantially disproportionate

17. Petitioner emphasizes (p. 34) the statement in the Senate Committee report that Section 302(c) "provides rules for determination of the constructive ownership of stock *for the purpose of Section 302.*" But the phrase "for the purpose of Section 302" provides no further clue to what was intended than the phrase "for the purposes of this section" in the Act itself, from which the general statement in the report is adopted.

test and the termination of interest test. The Committee said: "However, *in order to prevent tax avoidance*, your committee follows the rules of the House bill whereby, *under specific circumstances*, a shareholder may be considered as owning stock held by members of his family (or by partnerships, corporations, or estates trusts in which he has an interest)." (Emphasis supplied). It is highly significant that the attribution rules were retained "for purposes of preventing tax avoidance" and for no other expressed purpose, and further, that the "specific instances" in which the attribution rules were to apply excluded instances embodied in present Section 302(b)(1) for the very simple reason that there was no provision in the House bill analogous to Section 302(b)(1).

Since Congress intended to perpetuate, at least "in general," the "existing law," we submit that Congress would have been most explicit if it had really intended to graft onto this existing law the fiction of constructive ownership of stock."[18] In establishing the formal or "safe harbor" tests of paragraphs (2) and (3) of Section 302(b), based on ownership of stock, it was appropriate to retain the attribution rules of the House bill to prevent tax avoidance. Paragraph (1), however, merely perpetuates the principle of substance over form of Section 115(g)(1) of the 1939 Code. A question of substance over form should always be decided by factual inquiry on the basis of reality rather than fiction. Indeed, the Senate Committee's Detailed Explanation expressly states that the determination of dividend equivalence under Section

18. Petitioner makes no contention that by the use of the words "in general" the Senate Committee was trying to say that the attribution rules applied in determining dividend equivalence. Such a contention would lack plausibility in view of the specific references to the attribution rules in the explanations of paragraphs (2) and (3) of subsection (b) and the total absence of any such reference in the explanation of paragraph (1).

302(b) is to be "dependent, except when it is specifically provided otherwise, upon a factual inquiry."[19] Paragraph (1) of Section 302(b) does *not* "specifically provide otherwise."

An ambiguous statutory provision should be construed to accomplish a rational rather than an incongruous result and to avoid constitutional doubts. The existing law to which Congress intended to revert when it added Section 302(b)(1) to the "safe harbor" tests adapted from the House bill (which were packaged with the attribution rules) was realistic rather than formal. To hitch the arbitrary attribution rules to the earlier test of realism brings about a more incongruous result than the centaur of ancient mythology—a man's head and torso on a horse's body, —as the instant case well illustrates.

Let us suppose that Tennessee Foundry & Machine Company had no current earnings but had accumulated earnings and profits of exactly $25,000 when the preferred stock was redeemed, and that after the redemption, the corporation paid a dividend of $25,000 to the common stockholders. If the petitioner's position is correct, the common stockholders would receive no taxable income (since earnings and profits had been exhausted), while the respondent would have been subjected to double taxation—first, on the income from which the original $25,000 was derived, with which the preferred stock was purchased, and, second, on the $25,000 received when the preferred stock was redeemed.

If this incongruous result does not shock the Court where taxpayer's wife and children are the beneficiaries (along with the Treasury, of course), it must be remem-

19. 3 U. S. Code Cong. & Adm. News, 83d Cong. (2d Sess.) 1954, p. 4870.

bered that the attribution rules also apply as between partnership and partners. Suppose that a partnership with numerous partners owns the preferred stock and a single partner owns all the common stock. Here the one partner owning the common stock would benefit at the expense of all the other partners. Moreover, the Treasury, by regulation, has sought to give this one partner (in the assumed illustration) an additional benefit. It has provided that the basis of the redeemed preferred stock shall be added to the basis of the common stock owned and retained by the person whose ownership has been attributed to the taxpayer.[20] There is no statutory authority for this regulation, which perhaps demonstrates the Treasury's recognition of the inequity of the provision in its regulation that "one of the facts to be considered" in deciding dividend equivalence is constructive ownership under Section 318(a). We insist that this portion of Treas. Reg. § 1.302-2(b) is invalid, for all the reasons heretofore stated.

The lower courts have followed the Treasury regulation, but with one qualification: in the case of family estrangement. *Herbert C. Parker*, T.C. Memo. 1961-176, 20 T.C.M. 893. In *Levin* v. *Commissioner*, 385 F. 2d 521 (C.A. 2), the Court said in this connection (p. 527):

> "We do not hold that there may not be cases in which strict application of the attribution rules may be inappropriate. In addition to the preferred stock situations referred to in the Senate Report quoted supra [redemptions where the shareholder has no control over when the redemption may take place], family estrangement may render the application of the family attribution rules unwise. . . ."

In a recent case the Tax Court, in applying the attribution rules, said that the evidence showed "an almost touch-

20. Treas. Reg. Section 1.302-2(c) cited by petitioner in Footnote 12, p. 15.

ing picture of family affection, trust and cooperation." *Leon R. Meyer*, 46 T.C. 65, 89. To the same effect, see *Bradbury* v. *Commissioner of Internal Revenue*, 298 F. 2d 111, 116-7 (C.A. 1). As previously pointed out, the attribution rules also apply between partnership and partner, and likewise between beneficiary and trustee. How can the tax practitioner, the revenue agent, and ultimately the Court, decide just what degree of estrangement will prevent application of the attribution rules to Section 301 (b)(1) under the varying circumstances which may arise among these groups of related persons?

The answer is, of course, that there can be no judge-made exceptions to statutory rules. Either a statutory rule is applicable or it is not applicable. There is no question about applicability of the attribution rules to paragraphs (2) and (3) of subsection (b), with the statutory exception of Section 318(a)(1)(A)(i),—a spouse "who is legally separated from the individual with a decree of divorce or separate maintenance." To say that judge-made exceptions are allowable with respect to paragraph (1) is really to say that the rules do not apply to paragraph (1).

If we are correct in our insistence that the attribution rules do not apply to Section 302(b)(1), we must go back to "existing law" under Section 115(g)(1) of the 1939 Code, where the question of family relationships arose in a few decided cases. It is clear that ownership of stock by adult children, with separate families and homes of their own, would not have been attributed to the parent.[21]

21. See *In re Lukens' Estate*, 246 F. 2d 403 (C.A. 3), and cases cited, p. 407.

No Decision in Conflict with Decisions Below

While the lower courts have followed the Treasury regulation in holding the attribution rules applicable to Section 302(b)(1), there is no decided case in which a redemption of either preferred or common stock has been held to be essentially equivalent to the distribution of a taxable dividend solely by virtue of these rules, where a genuine business purpose was found to exist. Petitioner has cited (p. 35) *Ballenger* v. *United States*, 301 F. 2d 192 (C.A. 4), and *Commissioner* v. *Berenbaum*, 369 F. 2d 337 (C.A. 10), but in both cases the distribution was substantially pro rata without applying the attribution rules. In *Ballenger* the taxpayer husband owned all the common stock except one share in the name of his wife, which the Court said was "too small to upset the pro rata characterization of the distribution." (301 F. 2d 199). With respect to the taxpayer in *Berenbaum*, "there was no reduction in his control, and only an insignificant reduction in ownership represented by the redeemed shares." (369 F. 2d 341).

In *Ballenger*, moreover, the Court expressly held that there was "no legitimate business purpose" for the redemption (301 F. 2d 199); and in *Berenbaum* the Court emphasized the failure of the taxpayer to "come forward with additional evidence on the question" [of business purpose] after the basic facts had been stipulated and the issue had been placed in controversy by the pleadings. (369 F. 2d 341). In *Bradbury*, *supra*, cited by petitioner (Brief, p. 35), the stockholder had borrowed money from the corporation for personal use and then turned in stock for redemption in order to pay the debt and clean up the corporation's balance sheet. In *Levin*, *supra*, also cited, there was no contention of business purpose. In short,

there is no decided case in conflict with the decision in the instant case.

Petitioner does not controvert the finding that there was no tax avoidance purpose, but contends (pp. 25-32) that there was no business purpose in the redemption, basing this contention largely on the remark of the Court in *Ballenger, supra,* that "we cannot understand how a valid reason for the issuance of preferred stock can, once its purposes have been served, be converted into a reason for its redemption." The Fourth Circuit's difficulty in that respect was perhaps due to its mode of expression. There is, of course, no *converting* of a reason for the issuance of preferred stock into a reason for its redemption; but if preferred stock is issued for a temporary purpose, and is redeemed when that purpose has been served, the redemption cannot fairly be viewed in complete isolation.[22]

Petitioner argues (Footnote 21, pp. 26-27) that in *Keefe* v. *Cote,* 213 F. 2d 651 (C.A. 1), and in the Tax Court cases relying on it, there was a factor not present here, viz., that the preferred stock had in each case been issued for debts owing the taxpayer for compensation, which had been reported for income taxation, so that to tax the redemption proceeds would amount to double taxation. As petitioner correctly points out, however, the taxpayers were in no different position than if they had received cash for their services and thereafter acquired preferred stock. What petitioner overlooks is that double taxation would result just the same,—and that in the instant case, double taxation would also result. Respondent did not buy the preferred stock with money picked off a tree.

22. See cases cited in footnote 3, *supra,* p. 6.

Finally, any normal corporate board of directors in 1963, with surplus funds on deposit in a bank, and no anticipated need for them in the corporate business, would have redeemed outstanding 6% preferred stock at par, even in the absence of an understanding or agreement to do so. Petitioner says (p. 31, footnote 25) that this is not a business purpose because the corporation can convert preferred stock into common stock. But this preferred stock was not convertible into common stock at the option of the corporation, or even at the option of the holder. Petitioner further says that the same result could be achieved "by a simple surrender of the preferred shares without any cash distribution." But perhaps respondent needed the money, and did not feel impelled to make an indirect gift to his wife and adult children of $25,000, after having given them most of the common stock.

CONCLUSION

The judgment of the Court of Appeals affirming the judgment of the District Court should be affirmed by this Court.

Respectfully submitted,

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1969

No. 282

UNITED STATES OF AMERICA,
Petitioner,

vs.

MACLIN P. DAVIS and EDITH U. DAVIS,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR REHEARING

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SUPREME COURT OF THE UNITED STATES

No. 282. — October Term, 1969

UNITED STATES, Petitioner, v. **MACLIN P. DAVIS et ux.**	**On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.**

PETITION FOR REHEARING

TO THE HONORABLE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES

MAY IT PLEASE THE COURT:

Maclin P. Davis and wife, Edith U. Davis, respondents in the above case, respectfully petition the Court for a rehearing of the decision and judgment of March 23, 1970, remanding the case to the District Court for dismissal of the complaint. As in the opinion of the Court, Maclin P. Davis will be referred to as "taxpayer."

In the opinion of Mr. Justice Marshall, concurred in by four members of the Court, no mention whatever is made of taxpayer's fundamental contention (the first one made in his brief) that a return of capital is not "income" within the Sixteenth Amendment. The Court states in the opinion (p. 11) that "the difference between form and substance in the tax law is largely problematical." But on a constitutional issue, the problem must be squarely faced. We respectfully refer the Court to the discussion at pp. 3-6 of the reply brief, and to the quotation from *Eisner v. Macomber*, 252 U. S. 189, 206, in which this Court stated that the determination of what is and what is not "income" must

be "according to truth and substance, without regard to form." It is clearly within the competence of Congress, in making exceptions to the taxation of true income, to prescribe the form which must be followed by the taxpayer to take advantage of the exception. But, as stated by the Court in *Eisner v. Macomber*, it is not within the competence of Congress to "conclude the matter" of what is income by any test other than truth and substance.

The attribution rules are not truth and substance, but pure fiction, if applied to determine what is "income" within the Sixteenth Amendment. Moreover, the Court has apparently assumed that the sole owner of preferred stock and common stock of a corporation is affected in exactly the same way by the redemption of his preferred stock as by the redemption of a part of his common stock. Ownership of property is a bundle of rights (and privileges), and where a part of the common stock is redeemed, the sole stockholder's bundle is the same as before the redemption, except for the smaller number of shares, which is form and not substance. But the redemption of his preferred stock changes the bundle materially, because preferred stock is not fungible with common stock. Preferred stock can be, and in this case was, clearly earmarked as property separate and distinct from the common stock. Only in the complete liquidation of a corporation does the difference between preferred stock and common stock lose significance.

The rationale of the Court's decision is such that if a stockholder buys preferred stock one day, and sells it the very next day for the same money he paid for it (or even for the cancellation of a note given for it), the sales price is taxable income to the extent of the corporation's earnings and profits, provided only that, either in fact or by application of the attribution rules, the seller is the sole stockholder. We submit that no semantic legerdemain can justify such a fiction, which flies in the face of any concept of income "according to truth and substance." We continue to urge that Congress intended no such result. One purpose of Section 302(b)(1) of the Internal Revenue Code of 1954 was doubtless to provide a safety valve to save the constitutionality of the 1954 revision. But we respectfully submit that if the Court's conclu-

sion as to the meaning (or lack of meaning) of Section 302(b)(1) be accepted, the taxing statute is rendered clearly unconstitutional, because the result is to tax as income what is really a return of capital.[1]

Respectfully submitted,

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[1] Although this petition is predicated on the constitutional issue, we feel compelled also to challenge the Court's statement that if a transaction failed to qualify under Section 302(b)(2) or (3) solely because of the attribution rules "it would *according to taxpayer's argument* nonetheless qualify under Section 302(b)(1)." (Emphasis supplied.) Taxpayer's argument, to the contrary, is simply that such redemptions as are returns of capital would so qualify. The redemption of stock issued to the taxpayer as a stock dividend is an obvious example of a redemption which is not a return of capital.

CERTIFICATE

The foregoing petition for rehearing is presented in good faith and not for delay.

ROBERT G. MCCULLOUGH
WILLIAM WALLER

NOTICE: This opinion is subject to formal revision before publication in the preliminary print of the United States Reports. Readers are requested to notify the Reporter of Decisions, Supreme Court of the United States, Washington, D.C. 20543, of any typographical or other formal errors, in order that corrections may be made before the preliminary print goes to press.

SUPREME COURT OF THE UNITED STATES

No. 282.—October Term, 1969

United States, Petitioner, v. Maclin P. Davis et ux. | On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.

[March 23, 1970]

Mr. Justice Marshall delivered the opinion of the Court.

In 1945, taxpayer and E. B. Bradley organized a corporation.[1] In exchange for property transferred to the new company, Bradley received 500 shares of common stock, and taxpayer and his wife similarly each received 250 such shares. Shortly thereafter, taxpayer made an additional contribution to the corporation, purchasing 1,000 shares of preferred stock at a par value of $25 per share.

The purpose of this latter transaction was to increase the company's working capital and thereby to qualify for a loan previously negotiated through the Reconstruction Finance Corporation. It was understood that the corporation would redeem the preferred stock when the RFC loan had been repaid. Although in the interim taxpayer bought Bradley's 500 shares and divided them between his son and daughter, the total capitalization of the company remained the same until 1963. That year, after the loan was fully repaid and in accordance with the original understanding, the company redeemed taxpayer's preferred stock.

[1] References in this opinion to "taxpayer" are to Maclin P. Davis. His wife is a party solely because joint returns were filed for the year in question.

In his 1963 personal income tax return taxpayer did not report the $25,000 received by him upon the redemption of his preferred stock as income. Rather, taxpayer considered the redemption as a sale of his preferred stock to the company—a capital gains transaction under § 302 of the Internal Revenue Code of 1954 resulting in no tax since taxpayer's basis in the stock equaled the amount he received for it. The Commissioner of Internal Revenue, however, did not approve this tax treatment. According to the Commissioner, the redemption of taxpayer's stock was essentially equivalent to a dividend and was thus taxable as ordinary income under §§ 301 and 316 of the Code. Taxpayer paid the resulting deficiency and brought this suit for a refund. The District Court ruled in his favor, 274 F. Supp. 466 (D. C. M. D. Tenn. 1967), and on appeal the Court of Appeals affirmed. 408 F. 2d 1139 (C. A. 6th Cir. 1969).

The Court of Appeals held that the $25,000 received by taxpayer was "not essentially equivalent to a dividend" within the meaning of that phrase in § 302 (b)(1) of the Code because the redemption was the final step in a course of action that had a legitimate business (as opposed to tax avoidance) purpose. That holding represents only one of a variety of treatments accorded similar transactions under § 302 (b)(1) in the circuit courts of appeals.[2] We granted certiorari, 396 U. S. 815 (1969),

[2] Only the Second Circuit has unequivocally adopted the Commissioner's view and held irrelevant the motivation of the redemption. See *Levin* v. *Commissioner*, 385 F. 2d 521 (1967); *Hasbrook* v. *United States*, 343 F. 2d 811 (1965). The First Circuit, however, seems almost to have come to that conclusion, too. Compare *Weisman* v. *United States*, 371 F. 2d 816 (1967), with *Bradbury* v. *Commissioner*, 298 F. 2d 111 (1962).

The other courts of appeals that have passed on the question are apparently willing to give at least some weight under § 302 (b)(1) to the business motivation of a distribution and redemption. See,

in order to resolve this recurring tax question involving stock redemptions by closely held corporations. We reverse.

I

The Internal Revenue Code of 1954 provides generally in §§ 301 and 316 for the tax treatment of distributions by a corporation to its shareholders; under those provisions, a distribution is includable in a taxpayer's gross income as a dividend out of earnings and profits to the extent such earnings exist.[2] There are exceptions to the application of these general provisions, however, and among them are those found in § 302 involving certain distributions for redeemed stock. The basic question in this case is whether the $25,000 distribution by the corporation to taxpayer falls under that section—more specifically, whether its legitimate business motivation qualifies the distribution under § 302 (b)(1) of the Code. Preliminarily, however, we must consider the relationship between § 302 (b)(1) and the rules regarding the attribution of stock ownership found in § 318 (a) of the Code.

Under subsection (a) of § 302, a distribution is treated as "payment in exchange for the stock," thus qualifying

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e. g., Commissioner v. *Berenbaum*, 369 F. 2d 337 (C. A. 10th Cir. 1966); *Kerr* v. *Commissioner*, 326 F. 2d 225 (C. A. 9th Cir. 1964); *Ballenger* v. *United States*, 301 F. 2d 192 (C. A. 4th Cir. 1962); *Heman* v. *Commissioner*, 283 F. 2d 227 (C. A. 8th Cir. 1960); *United States* v. *Fewell*, 255 F. 2d 496 (C. A. 5th Cir. 1958). See also *Neff* v. *United States*, 157 Ct. Cl. 322, 305 F. 2d 455 (1962). Even among those courts that consider business purpose, however, it is generally required that the business purpose be related not to the issuance of the stock, but to the redemption of it. See *Commissioner* v. *Berenbaum*, *supra*; *Ballenger* v. *United States*, *supra*.

[2] See, *e. g.*, *Commissioner* v. *Gordon*, 391 U. S. 83, 88–89 (1968). Taxpayer makes no contention that the corporation did not have $25,000 in accumulated earnings and profits.

for capital gains rather than ordinary income treatment, if the conditions contained in any one of the four paragraphs of subsection (b) are met. In addition to paragraph (1)'s "not essentially equivalent to a dividend" test, capital gains treatment is available where (2) the taxpayer's voting strength is substantially diminished, (3) his interest in the company is completely terminated, or (4) certain railroad stock is redeemed. Paragraph (4) is not involved here, and taxpayer admits that paragraphs (2) and (3) do not apply. Moreover, taxpayer agrees that for the purposes of §§ 302 (b)(2) and (3) the attribution rules of § 318 (a) apply and he is considered to own the 750 outstanding shares of common stock held by his wife and children in addition to the 250 shares in his own name.[4]

Taxpayer, however, argues that the attribution rules do not apply in considering whether a distribution is essentially equivalent to a dividend under § 302 (b)(1). According to taxpayer, he should thus be considered to own only 25 percent of the corporation's common stock, and the distribution would then qualify under § 302 (b)(1) since it was not pro rata or proportionate to his stock interest, the fundamental test of dividend

[4] Section 318 (a) provides in relevant part as follows:

"General rules.—For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

"(1) Members of family.—

"(A) In general.—An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

"(i) his spouse (other than spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and

"(ii) his children, grandchildren, and parents."

In § 318 (b) the rules contained in subsection (a) are made specifically applicable to "section 302 (relating to the redemption of stock)."

equivalency. See Treas. Reg. 1.302–2 (b). However, the plain language of the statute compels rejection of the argument. In subsection (c) of § 302, the attribution rules are made specifically applicable "in determining the ownership of stock for purposes of this section." Applying this language, both courts below held that § 318 (a) applies to all of § 302, including § 302 (b)(1)—a view in accord with the decisions of the other courts of appeals,[5] a longstanding treasury regulation,[6] and the opinion of the leading commentators.[7]

Against this weight of authority, taxpayer argues that the result under paragraph (1) should be different because there is no explicit reference to stock ownership as there is in paragraphs (2) and (3). Neither that fact, however, nor the purpose and history of § 302 (b)(1) support taxpayer's argument. The attribution rules—designed to provide a clear answer to what would otherwise be a difficult tax question—formed part of the tax bill that was subsequently enacted as the 1954 Code. As is discussed further, *infra*, the bill as passed by the House of Representatives contained no provision comparable to § 302 (b)(1). When that provision was added in the Senate, no purpose was evidenced to restrict the applicability of § 318 (a). Rather, the attribution rules continued to be made specifically applicable to the entire section, and we believe that Congress intended that they be taken into account wherever ownership of stock was relevant.

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[5] See *Levin* v. *Commissioner*, 385 F. 2d 521, 526–527 (C. A. 2d Cir. 1967); *Commissioner* v. *Berenbaum*, 369 F. 2d 337, 342 (C. A. 10th Cir. 1966); *Ballenger* v. *United States*, 301 F. 2d 192, 199 (C. A. 4th Cir. 1962); *Bradbury* v. *Commissioner*, 298 F. 2d 111, 116–117 (C. A. 1st Cir. 1962).

[6] See Treas. Reg. 1.302–2 (b).

[7] See B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Stockholders 292, n. 32 (2d ed. 1966).

Indeed, it was necessary that the attribution rules apply to § 302 (b)(1) unless they were to be effectively eliminated from consideration with regard to §§ 302 (b)(2) and (3) also. For if a transaction failed to qualify under one of those sections solely because of the attribution rules, it would according to taxpayer's argument nonetheless qualify under § 302 (b)(1). We cannot agree that Congress intended so to nullify its explicit directive. We conclude, therefore, that the attribution rules of § 318 (a) do apply; and, for the purposes of deciding whether a distribution is "not essentially equivalent to a dividend" under § 302 (b)(1), taxpayer must be deemed the owner of all 1,000 shares of the company's common stock.

II

After application of the stock ownership attribution rules, this case viewed most simply involves a sole stockholder who causes part of his shares to be redeemed by the corporation. We conclude that such a redemption is always "essentially equivalent to a dividend" within the meaning of that phrase in § 302 (b)(1) [8] and therefore do not reach the Government's alternative argument that in any event the distribution should not on the facts of this case qualify for capital gains treatment.[9]

[8] Of course, this just means that a distribution in redemption to a sole shareholder will be treated under the general provisions of § 301, and it will only be taxed as a dividend under § 316 to the extent that there are earnings and profits.

[9] The Government argues that even if business purpose were relevant under § 302 (b)(1), the business purpose present here related only to the original investment and not at all to the necessity for redemption. See cases cited, n. 2, *supra*. Under either view, taxpayer does not lose his basis in the preferred stock. Under Treas. Reg. 1.302-2 (c) that basis is applied to taxpayer's common stock.

The predecessor of § 302 (b)(1) came into the tax law as § 201 (d) of the Revenue Act of 1921, 42 Stat. 228–229:

> "A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend . . . ."

Enacted in response to this court's decision that pro rata stock dividends do not constitute taxable income, *Eisner* v. *Macomber*, 252 U. S. 189 (1920), the provision had the obvious purpose of preventing a corporation from avoiding dividend tax treatment by distributing earnings to its shareholders in two transactions—a pro rata stock dividend followed by a pro rata redemption—that would have the same economic consequences as a simple dividend. Congress, however, soon recognized that even without a prior stock dividend essentially the same result could be effected whereby any corporation, "especially one which has only a few stockholders, might be able to make a distribution to its shareholders which would have the same effect as a taxable dividend." H. R. Rep. No. 1, 69th Cong., 1st Sess., at 5. In order to cover this situation, the law was amended to apply "(whether or not such stock was issued as a stock dividend)" whenever a distribution in redemption of stock was made "at such time and in such manner" that it was essentially equivalent to a taxable dividend. Revenue Act of 1926, § 201 (g), 44 Stat. 11.

This provision of the 1926 Act was carried forward in each subsequent revenue act and finally became

§ 115 (g)(1) of the Internal Revenue Code of 1939. Unfortunately, however, the policies encompassed within the general language of § 115 (g)(1) and its predecessors were not clear, and there resulted much confusion in the tax law. At first, courts assumed that the provision was aimed at tax avoidance schemes and sought only to determine whether such a scheme existed. See, *e. g.*, *Commissioner* v. *Quackenbos*, 78 F. 2d 156 (C. A. 2d Cir. 1935). Although later the emphasis changed and the focus was more on the effect of the distribution, many courts continued to find that distributions otherwise like a dividend were not "essentially equivalent" if, for example, they were motivated by a sufficiently strong nontax business purpose. See cases cited n. 2, *supra*. There was general disagreement, however, about what would qualify as such a purpose, and the result was a case-by-case determination with each case decided "on the basis of the particular facts of the transaction in question." *Bains* v. *United States*, 153 Ct. Cl. 599, 603, 289 F. 2d 644, 646 (1961).

By the time of the general revision resulting in the Internal Revenue Code of 1954, the draftsmen were faced with what has aptly been described as "the morass created by the decisions." *Ballenger* v. *United States*, 301 F. 2d 192, 196 (C. A. 4th Cir. 1962). In an effort to eliminate "the considerable confusion which exists in this area" and thereby to facilitate tax planning, H. R. Rep. No. 1337, 83d Cong., 2d Sess., at 35, the authors of the new Code sought to provide objective tests to govern the tax consequences of stock redemptions. Thus, the tax bill passed by the House of Representatives contained no "essentially equivalent" language. Rather, it provided for "safe harbors" where capital gains treatment would be accorded to corporate redemptions that met the conditions now found in §§ 302 (b)(2) and (3) of the Code.

It was in the Senate Finance Committee's consideration of the tax bill that § 302 (b)(1) was added, and Congress thereby provided that capital gains treatment should be available "if the redemption is not essentially equivalent to a dividend." Taxpayer argues that the purpose was to continue "existing law," and there is support in the legislative history that § 302 (b)(1) reverted "in part" or "in general" to the "essentially equivalent" provision of § 115 (g)(1) of the 1939 Code. According to the Government, even under the old law it would have been improper for the Court of Appeals to rely on "a business purpose for the redemption" and "an absence of the proscribed tax avoidance purpose to bail out dividends at favorable tax rates." See *Northrup* v. *United States*, 240 F. 2d 304, 307 (C. A. 2d Cir. 1957); *Smith* v. *United States*, 121 F. 2d 692, 695 (C. A. 3d Cir. 1941); cf. *Commissioner* v. *Estate of Bedford*, 325 U. S. 283 (1945). However, we need not decide that question, for we find from the history of the 1954 revisions and the purpose of § 302 (b)(1) that Congress intended more than merely to re-enact the prior law.

In explaining the reason for adding the "substantially equivalent" test, the Senate Committee stated that the House provisions "appeared unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place." S. Rep. No. 1622, 83d Cong., 2d Sess., at 44. This explanation gives no indication that the purpose behind the redemption should affect the result.[10] Rather, in its more detailed technical evalua-

[10] See Bittker & Eustice, *supra*, n. 6, at 291: "It is not easy to give § 302 (b)(1) an expansive construction in view of this indication that its major function was the narrow one of immunizing redemptions of minority holdings of preferred stock."

tion of § 302 (b)(1), the Senate Committee reported as follows:

> "The test intended to be incorporated in the interpretation of paragraph (1) is in general that currently employed under section 115 (g)(1) of the 1939 Code. Your committee further intends that in applying this test for the future that the inquiry will be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation. For this purpose the presence or absense of earnings and profits of the corporation is not material. Example: X, the sole shareholder of a corporation having no earnings or profits causes the corporation to redeem half of its stock. Paragraph (1) does not apply to such redemption notwithstanding the absense of earnings and profits." S. Rep. No. 1622, *supra*, at 234.

The intended scope of § 302 (b)(1) as revealed by this legislative history is certainly not free from doubt. However, we agree with the Government that by making the sole inquiry relevant for the future the narrow one whether the redemption could be characterized as a sale, Congress was apparently rejecting past court decisions that had also considered factors indicating the presence or absence of a tax avoidance motive.[11] At least that is

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[11] This rejection is confirmed by the Committee's acceptance of the House treatment of distributions involving corporate contractions—a factor present in many of the earlier "business purpose" redemptions. In describing its action, the Committee stated as follows:

"Your committee, as did the House bill, separates into their significant elements the kind of transactions now incoherently aggregated in the definition of a partial liquidation. Those distributions which may have capital-gain characteristics *because they are*

the implication of the example given. Congress clearly mandated that pro rata distributions be treated under the general rules laid down in §§ 301 and 316 rather than under § 302, and nothing suggests that there should be a different result if there were a "business purpose" for the redemption. Indeed, just the opposite inference must be drawn since there would not likely be a tax avoidance purpose in a situation where there were no earnings or profits. We conclude that the Court of Appeals was therefore wrong in looking for a business purpose and considering it in deciding whether the redemption was equivalent to a dividend. Rather, we agree with the Court of Appeals for the Second Circuit that: "the business purpose of a transaction is irrelevant in determining dividend equivalency" under § 302 (b)(1). *Hasbrook* v. *United States*, 343 F. 2d 811, 814 (1965).

Taxpayer strongly argues that to treat the redemption involved here as essentially equivalent to a dividend is to elevate form over substance. Thus, taxpayer argues, had he not bought Bradley's shares or had he made a subordinated loan to the company instead of buying preferred stock, he could have gotten back his $25,000 with favorable tax treatment. However, the difference between form and substance in the tax law is largely problematical, and taxpayer's complaints have little to do with whether a business purpose is relevant under § 302 (b)(1). It was clearly proper for Congress to treat distributions generally as taxable dividends when made out of earnings and profits and then to prevent

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not made pro rata among the various shareholders would be subjected, at the shareholder level, to the separate tests described in [§§ 301 to 318]. On the other hand, those distributions characterized by what happens solely at the corporate level by reason of the assets distributed would be included as within the concept of a partial liquidation." S. Rep. No. 1622, *supra*, at 49. (Emphasis added.)

avoidance of that result without regard to motivation where the distribution is in exchange for redeemed stock.

We conclude that that is what Congress did when enacting § 302 (b)(1). If a corporation distributes property as a simple dividend, the effect is to transfer the property from the company to its shareholders without a change in the relative economic interests or rights of the stockholders. Where a redemption has that same effect, it cannot be said to have satisfied the "not essentially equivalent to a dividend" requirement of § 302 (b)(1). Rather, to qualify for preferred treatment under that section, a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation. Clearly, taxpayer here, who (after application of the attribution rules) was the sole shareholder of the corporation both before and after the redemption, did not qualify under this test. The decision of the Court of Appeals must therefore be reversed and the case remanded to the District Court for dismissal of the complaint.

It is so ordered.

SUPREME COURT OF THE UNITED STATES

No. 282.—October Term, 1969

United States, Petitioner, *v.* Maclin P. Davis et ux.	On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.

[March 23, 1970]

Mr. Justice Douglas, with whom The Chief Justice and Mr. Justice Brennan concur, dissenting.

I agree with the District Court, 274 F. Supp. 466, and with the Court of Appeals, 408 F. 2d 1139, that respondent's contribution of working capital in the amount of $25,000 in exchange for 100 shares of preferred stock with a par value of $25 was made in order for the corporation to obtain a loan from the RFC and that the preferred stock was to be redeemed when the loan was repaid. For the reasons stated by the two lower courts, this redemption was not "essentially equivalent to a dividend," for the bona fide business purpose of the redemption belies the payment of a dividend. As stated by the Court of Appeals:

> "Although closely-held corporations call for close scrutiny under the tax law, we will not, under the facts and circumstances of this case, allow mechanical attribution rules to transform a legitimate corporate transaction into a tax avoidance scheme." 408 F. 2d, at 1144.

When the Court holds it was a dividend, it effectively cancels § 302 (b)(1) from the Code. This result is not a matter of conjecture, for the Court says that in case of closely-held or one-man corporations a redemption of stock is "always" equivalent to a dividend. I would leave such revision to the Congress.